28 Jun 2019 | Downgrade

Fitch Downgrades Syracuse Industrial Development Agency, NY PILOT Bonds to 'BBB'; Outlook Negative

Fitch Ratings-New York-28 June 2019: Fitch Ratings has downgraded to 'BBB' from 'A-' the following Syracuse Industrial Development Agency, New York (SIDA) bonds:

--Approximately $198.9 million PILOT revenue refunding bonds, series 2016A (Carousel Center Project);
--Approximately $10.6 million PILOT revenue refunding bonds, taxable series 2016B (Carousel Center Project);
--Approximately $87.6 million PILOT revenue bonds, series 2007B (Carousel Center Project).

The Rating Outlook is revised to Negative from Stable.

SECURITY
The bonds are secured by Payments in Lieu of Taxes (PILOTs) on the original or 'legacy' Carousel Center mall payable to SIDA by the Carousel Center Company LP (the Carousel Owner) pursuant to a PILOT agreement, and interest earnings on the debt service reserves. The debt service reserve funds total 125% of average annual debt service or about $31 million.

ANALYTICAL CONCLUSION
The downgrade to 'BBB' and Negative Outlook incorporate Fitch's belief that a recent trend of weaker performance of the Carousel Center and Destiny USA overall is likely to reduce the mall's value, potentially weakening the property owner's still-strong incentive and ability to make PILOT payments. The role of the mall's CMBS loan servicer in advancing the payments remains an important positive rating consideration. The rating incorporates the strong lien position of PILOT payments in the mall's debt structure, making payments highly likely as long as the property has at least modest value.

KEY RATING DRIVERS
POTENTIAL LTV RATIO WEAKENING: The rating downgrade incorporates Fitch's uncertainty about the current value of the mall property, given the property owner's recent extension rather than repayment or refinancing of the securitized CMBS loan and softer sales volume. However, the rating assumes significant value still exists, providing incentive for the mortgage servicer to continue making advances of PILOT payments.

SERVICER PROVIDES LIQUIDITY: The mortgage servicer, required as part of the securitization of the underlying commercial loan on the Carousel Center, is responsible for providing needed liquidity to cover any shortfalls in PILOT payments until mall operations recover or the PILOT lien is foreclosed.

PILOT LIEN STATUS: PILOT payments are on parity with all governmental fees and charges, all of which are

senior to other payment obligations. The mall has a significant amount of debt whose repayment is subordinate to the PILOTs.

SOLID TENANCY, OPERATIONS AND MARKET POSITION: The Carousel Center has limited competition in the Syracuse, New York region. Mall occupancy rates have weakened but remain solid and sales per square foot are strong compared to national norms. The mall continues to expand and diversify its offerings.

SINGLE-SITE RISK: The PILOTS are subject to concentration risk, as PILOT payments are secured by the obligations of a single income-producing property (the Carousel Center) with one owner.

No Issuer Default Rating: SIDA has no material exposure to operating risk. As such, Fitch has not assigned an Issuer Default Rating, and there is no related cap on the PILOT bond rating.

RATING SENSITIVITIES

DETERIORATION IN LTV CUSHION: A material decline in the estimated value of the Carousel Center indicating only modest value above the PILOT lien, would be a concern, as it may serve to diminish the willingness of the servicer to advance funds in the event of a PILOT payment shortfall.

OPERATIONAL WEAKENING: Indications of an inability to meet the debt yield targets set forth in the current securitized commercial loan agreement would result in a downgrade of the PILOT bonds.

ELIMINATION OF SERVICER LOAN: A refinancing without a servicer role similar to the current CMBS loan could lead to a downgrade of the PILOT bonds as the debt service reserve fund would be insufficient to cover PILOTs over an extended period of time. Subsequent lenders are incented to provide an advance mechanism to protect interests that are subordinate to claims of the PILOT bondholders.

GIC PROVIDER EVENT RISK: A decline in interest earnings available for debt service coverage due to a downgrade or other trigger affecting Wells Fargo & Company (Issuer Default Rating 'A+'/Stable), the provider of the guaranteed investment contract (GIC) in which a portion of debt service reserve funds are invested, could pressure the current rating.

ECONOMIC RESOURCE BASE

With approximately 26 million in annual customer visits, Destiny USA is the dominant shopping center in the Syracuse area and draws shoppers from Canada. The mall is made up of the Carousel Center and an expansion project completed in 2012. It is anchored by nationally recognized stores including Macy's, J.C. Penney and Lord & Taylor. In total, the mall includes over 100 retail tenants, restaurants, entertainment options (including a Regal Movie Theater and a go-kart track), as well as various outlet and discount stores. An Embassy Suites opened in 2017. Management reports efforts to expand non-retail offerings in recognition of the weak retail environment in the U.S. but does not plan to increase debt on the property.

Fitch is taking a more conservative view in its evaluation of CMBS loans in recognition of the evolving retail business model. For more information see "Fitch Ratings Says Tougher View of Malls in U.S. CMBS Warranted as Their Struggles Continue."

DEDICATED TAX CREDIT PROFILE

ADEQUATE BONDHOLDER PROTECTIONS

The obligation of the Carousel owner to pay the PILOTs is on par only with governmental charges and fees, all of which are senior to any other payment obligations. The requirement of the Carousel owner to make PILOTs is evidenced by a PILOT note, payable to SIDA. The bonds are further secured by PILOT mortgages granted by SIDA and the Carousel owner, encumbering their interests in the existing mall to the PILOT trustee. The PILOT mortgages do not extend to the expansion property. They impose a lien analogous to liens imposed by taxing authorities, and provide for similar remedies including foreclosure of property, providing a strong incentive to pay.

Mall tenants are contractually obligated to pay the Carousel owner, as additional rent, their pro rata portions of PILOTs, and payment of the PILOTs by the Carousel owner is absolute and unconditional, notwithstanding the inability of the Carousel owner to recover this payment from its tenants. Tenant leases generally have five- to 10-year expirations.

A non-impairment covenant by the city of Syracuse and New York State prohibits the city and state from altering the rights of the issuer to collect PILOTs.

SUM SUFFICIENT COVERAGE STRUCTURE

Annual debt service is structured on an ascending basis. Debt service on the bonds totals $20.5 million in 2019, increasing to about $36 million in 2035. In order to service this debt, PILOT payments are scheduled to grow by 4% annually through the final maturity of the bonds in 2036. The annual escalation of PILOTs adds pressure upon mall operations, but Fitch believes it is manageable. Parity bonds can only be issued as refunding bonds and may not increase debt service.

The bonds have cash-funded debt service reserve funds equal to 125% of average annual debt service of the PILOT bonds or $31 million in aggregate. Funds on deposit in the taxable series 2007B and 2016B bonds' debt service reserve fund are invested in a GIC with an expiration date of Jan. 1, 2036 (bond maturity). Earnings are guaranteed at 3.59% from the Royal Bank of Canada (GIC provider, 'AA'/Stable) and are used to pay debt service. Any event related to the GIC provider that could potentially reduce or interrupt investment returns could cause negative rating pressure.

PRESENCE OF MORTGAGE SERVICER AS A SOURCE OF LIQUIDITY

Fitch views the presence of a mortgage servicer (Wells Fargo) pursuant to the securitization of the underlying mortgage loans on the mall project as a favorable credit factor. Under the pooling and servicing agreement, the

mortgage servicer is required to advance funds when necessary to preserve the security of the mortgage loans. Given the subordinate nature of the underlying mortgage loan to the PILOT bonds, this includes funds to make PILOT payments. The obligation to advance applies as long as the servicer (or special servicer) determines that the advances will be repaid. Servicer advances provide temporary cash flow support should pledged funds prove insufficient to cover all PILOTS until such time that either mall performance recovers or the property is foreclosed.

CHALLENGES EVIDENT IN LOAN EXTENSIONS

The $300 million mortgage loan on the legacy (Carousel) property along with a $130 million mortgage on the expansion project have been securitized as commercial mortgage pass-through certificates. Both loans are interest only and were originally due in June 2019. The loans were transferred to a special servicer in March 2019 amid questions about the combined property owner's ability to repay or refinance the loans.

A Loan Extension and Modification Agreement was signed on May 31, providing a conditional three-year extension. The second two years of the extension require the property to meet a debt yield test that requires improvement in net operating income or repayment of a portion of the loans. The owner has provided data indicating that the first debt yield test, which requires net operating income (NOI) of the combined property to be at least 7.5% of the loan balance by April 2020 in order to extend the loan to June 2021, would be met if calculated presently. The second debt yield test, required for the third year of the loan extension, requires NOI of 8.5% by April 2021. The servicer arrangement remains in place through the loan extension period.

The senior obligation of the PILOTs, on par with property taxes, ensures that support funding and any proceeds from foreclosure will be allocated first to the PILOTs before the excess is utilized for underlying mortgage claims.

MALL VALUE UNCERTAIN; PROPERTY FUNDAMENTALS REMAIN SATISFACTORY

The most recent appraisal of the Carousel Center was in July 2016, when the mall was valued at $500 million. This was down from the appraised value of $550 million in 2006, but up from the $490 million appraised value in 2014. Given the declining total sales and Pyramid's apparent difficulty in refinancing its securitized commercial loans, Fitch has concerns about declines in the mall's current and future value and the implication for leverage.

Mall operations continue to be supported by the dominant market position of the mall and the broad geographic area from which mall customers are derived. As of December 2018, occupancy for the Carousel Center was 89%, up slightly from 2017. Sales per square foot of mall shops (tenants with less than 10,000 square feet of leased space) were strong at $605 but down slightly from $611 as of Dec. 31, 2017 and incorporate declines in leased square footage and total sales. Aggregate occupancy at Destiny USA is weaker, reportedly due to a large presence of outlet stores experiencing high vacancies in the expansion section (which is not part of bond security).

PROJECT SUMMARY

Opened in 1990 in Syracuse, New York, the original Carousel Center mall is a 1.5 million square foot super-regional shopping center with easy access from Interstate 81, a major north-south highway that runs from Tennessee to the Canada/New York border.

An expansion project was completed in 2012 which added approximately 850,000 square feet of gross leasable area (GLA) and is fully integrated with the original mall. The expanded mall was rebranded to Destiny USA and totals 2.4 million square feet, making it the sixth largest mall in the country.

The Carousel owner is a wholly owned subsidiary of the Pyramid Company of Onondaga, which is part of the Pyramid Companies. Based in Syracuse, New York, Pyramid Companies was established in 1969 and has developed malls across the northeast portion of the U.S.

CONCENTRATION AND MARKET RISKS

As a single-site property with one owner the mall is subject to concentration risk. This risk is partly mitigated by the large and diverse number of tenants whose leases include the payment of a proportionate share of the PILOT burden. However, mall performance is also vulnerable to changes in the competitive landscape and overall trends in retailing. These risks are heightened by the long-term tenor of the bonds, which extend to 2036.

CRITERIA VARIATION

The analysis supporting the 'BBB' PILOT revenue bonds rating includes a variation from the U.S. Tax-Supported Rating Criteria. A variation was made to the dedicated tax bond analysis by incorporating an analysis of the transaction's overall leverage, or loan-to-value cushion, calculated by dividing the total amount of debt by the value of the property. This evaluation is supported by Fitch's U.S. Tax-Supported Rating Criteria, which includes modifications to the analysis of the dedicated revenue stream coverage cushions to address factors specific to a transaction. The revenue volatility that would be produced through the Fitch Analytical Sensitivity Tool does not anticipate this dedicated revenue source, which is derived from the value of the property.

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Applicable Criteria

U.S. Public Finance Tax-Supported Rating Criteria (pub. 03 Apr 2018)

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