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## Retail

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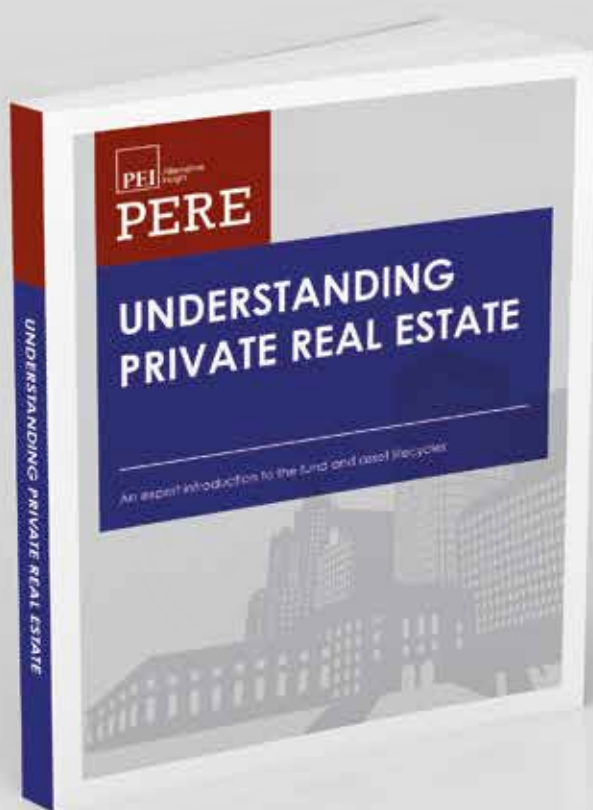
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### Contributing Authors

- AXA Real Estate
- Driver Jonas Deloitte
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- Hawkeye Partners
- Jones Lang LaSalle
- JP Morgan Asset Management
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- Nabarro
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## How to contact us

Senior Editor, Real Estate

**Jonathan Brasse**

jonathan.b@peimedia.com,  
+44 20 7566 4278

Editor

**Evelyn Lee**

evelyn.l@peimedia.com, +44 20 3640 7511

Special Projects Editor

**Helen Lewer**

helen.l@peimedia.com, +44 20 7566 5478

Senior Reporters

**Arshiya Khullar**

akhullar@peimedia.com, +852 2153 3149

**Kyle Campbell**

kyle.c@peimedia.com, +1 646 545 4428

Reporters

**Lisa Fu**

lisa.f@peimedia.com, +1 212 937 0384

**Christie Ou**

christie.o@peimedia.com, +852 2153 3247

Contributors

**Kyle Campbell, Mark Cooper, Lisa Fu,  
Jesse Koppi, Stuart Watson**

Managing Editor, Production: **Mike Simlett**

Head of Production: **Greg Russell**

Production Editors: **Daniel Blackburn,  
Adam Koppeser**

Copy Editor: **Eric Fish**

Head of Design: **Miriam Vysna**

Senior Designer: **Lee Southey**

Designers: **Denise Berjak, Carmen Graham,  
Glen Reynolds**

Head of Marketing Solutions, Real Assets Group:

**Nick Hayes**

nick.h@peimedia.com, +44 20 7566 5448

Marketing Solutions Manager:

**Annie Liu**

annie.l@peimedia.com, + 852 2153 3843

Subscriptions and reprints

subscriptions@peimedia.com

Customer Service

customerservices@peimedia.com

Editorial Director: **Philip Borel**

Director, Digital Product Development:

**Amanda Janis**

Director of Research & Analytics: **Dan Gunner**

Managing Director, Americas: **Colm Gilmore**

Managing Director, Asia: **Chris Petersen**

Group Managing Director, Brands and Markets:  
**Paul McLean**

Chief Executive: **Tim McLoughlin**

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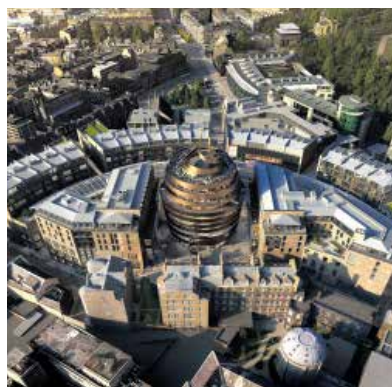
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# Insight

**N**o one wants to invest in retail real estate. That is the message conveyed by PERE data for retail-specific fundraising in the fourth quarter of 2018 and first quarter of this year, *writes Stuart Watson.*

Around the globe during that period no capital was raised and no funds closed. Zero. Of course, the situation is much more complex and nuanced than that bald figure suggests, but it does reflect the overwhelmingly negative sentiment surrounding the asset class at present.

For some time now retail has been supplanted in investors' affections by logistics and residential. Sector-specific fundraising for those asset classes totaled \$11.5 billion and \$11.2 billion in 2018 respectively, dwarfing retail's total of \$2.4

## Changing times A pall of gloom hangs over retail, but some see value in the asset class. Could attitudes to the sector be about to turn?

billion. Can the outlook for the sector really be that bleak? Or could the tide be about to turn?

Fundraising figures for the second quarter of 2019 will at least be boosted by the \$800 million final close of Charlotte, North Carolina-based Asana Partners' retail-focused Asana Partners Fund II. Looking back a little, other retail funds have met their capital-raising expectations: in July last year Sterling Organization, a Florida-headquartered retail specialist, raised \$495 million

for a value-add fund, and London-headquartered investment manager Meyer Bergman closed its Meyer Bergman European Retail Partners III fund at the beginning of 2018 having netted €816 million.

Meyer Bergman's founder and CEO, Marcus Meijer, is at pains to point out that vehicle is actually a mixed-use fund, however, and includes no shopping centers. "In hindsight we probably should have dropped the 'retail' for fund three," he says.

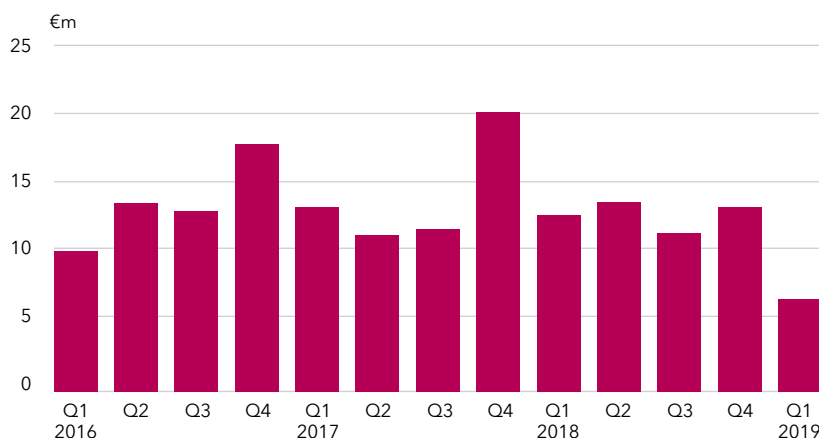
The company's fourth vehicle, for which it is raising capital at present will go by the title of an "urban real estate" fund, and, like its predecessor, will include logistics assets.

"If you come to a meeting and people think that you are going to talk about a retail fund - even if, like us, they think there are still opportunities in retail - the mandate from their CIO and executive board often says that retail is not a strategy that they want to allocate to right now," observes Meijer.

### Declining activity

The cost pressures and competition from e-commerce that have afflicted brick-and-mortar retailers are well-attested, and that negative perception is reinforced on

European retail real estate investment fell markedly quarter on quarter from Q4 2018 to Q1 2019



Source: PERE



Edinburgh St James:  
Nuveen is backing  
this mixed-use  
development in  
Scotland's capital

an almost daily basis by news of major chains retrenching or going bankrupt. Moreover, many investors worry that they are over-exposed to the asset class already, says Meijer: "A lot of them are sitting on shopping centers that have fallen in value quite significantly, and a lot are holding stock in the REITs like Hammerson, Intu, Klépierre and Unibail-Rodamco-Westfield, the value of which has also been declining, but they can't sell at prices that are anywhere close to those at which they would consider selling."

Chris Gardener, head of European retail investment at brokers CBRE, has noted a "vast reduction" in market activity at the end of 2018 and start of this year. His firm calculates that total European retail investment was €12.8 billion in the first quarter of 2018, but only €6.7 billion in the corresponding period this year. "With fewer buyers in the market and declining liquidity, owners of retail real estate find themselves in a position where

“There is more capital leaving the space than coming into it, which is pushing prices down”

Brian Kosoy, Sterling Organization

it often makes more sense for them to hold on to their portfolios and refinance them rather than exit," he says.

A similar pattern has emerged in the US, says Garrick Brown, head of retail research for the Americas at consultant Cushman & Wakefield: "We have seen about a 50 percent decline in investment activity. The buyer pool has shrunk and they generally chase after class A and trophy assets, but the current owners don't want to sell."

Nevertheless, some managers still believe that they can find value in some corners of the asset class. The mood music surrounding retail has led to some institutional investors "throwing the baby out with the bathwater," argues Sterling Organization president and CEO Brian Kosoy. "There is more capital leaving the space than coming into it, which is pushing prices down, while the capital coming into the space is focused on very specific product types, which has created

\$0

**Capital raised for retail-specific  
strategies around the world in Q4  
2018 and Q1 2019 (PERE)**

a bifurcated market. The spread between core gateway market properties versus non-core secondary assets is as big as I have ever seen.”

Kosoy remains cautious about shopping centers: he estimates that perhaps 500 of America’s 1,200 or so covered malls will not survive the current turbulence. However, he believes that it is still possible to make double-digit returns by buying fundamentally sound real estate in out-of-favor categories like neighborhood and power centers in strong markets with low and defensive rents.

### Good opportunities

If you are going to invest in shopping centers, it is important to own the best, observes Myles White head of retail for Europe at global investment manager Nuveen Real Estate.

“Large-scale prime experiential retail, which is often located in the more dominant malls has a very strong future, particularly where there is a strong tourist base or food anchor,” he says.

Nuveen is one of the few investors backing major development in the sector at the moment, and is committed to delivering the 1.7 million-square-foot Edinburgh St James mixed-use project in Scotland.

White is also bullish about the designer outlet sector. “Outlets have been the strongest performing of our retail

“You have to wait for the rents to come down to more realistic levels to start investing again”

Marcus Meijer, Meyer Bergman

investments across all our different funds. That has been because of a combination of consistent income, growth in income and improving cap rates,” he says.

Nuveen has formed joint ventures to invest in and develop outlet centers in Europe and in China. “That is offering the Chinese consumer the same experience they get in Europe with the same theater of building with a guarantee of origin of the goods. It also follows the trend of the creation of wealth in countries like China and the growing ability for them to spend that wealth.”

Meijer says there are still good opportunities in high-street retail, but only where rents are affordable: “If you are in a location where there is footfall,

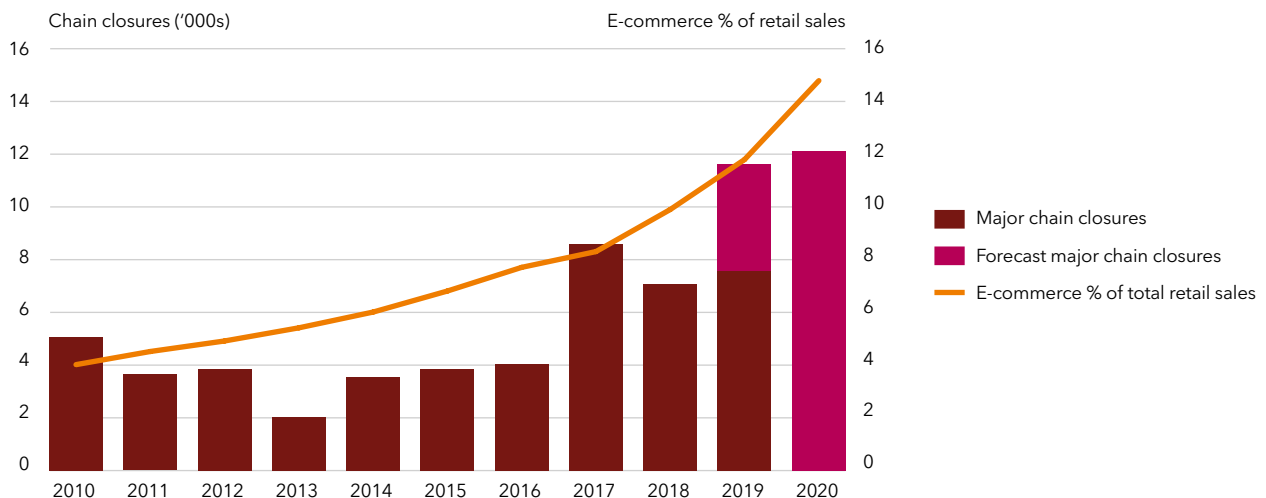
tourism and a well-developed retail environment there is still demand from retailers, but only when they feel they can make good money from that store. In places where rents have been pushed too high – London, New York and Los Angeles are generally over-rented, more so than cities in continental Europe – you have to wait for the rents to come down to more realistic levels to start investing again.”

In some areas of the market, notably secondary shopping centers, liquidity is close to drying up altogether. Opportunistic investors are poised to call the bottom of the market and snap up redevelopment and repositioning opportunities. Few have so far taken the plunge, though. The asset class may have reached its nadir, but concerns remain that it may still have further to fall.

In the meantime, however, people will continue to buy goods and retailers will need stores from which to sell them. Kosoy argues that in a period of rapid technological disruption it is unfair that retailing has been singled out.

“The world is changing fast in relation to all industries, but for some reason retail has become a poster-child for that change,” he says. “A lot of that is because of Amazon, but tell me what the auto or entertainment industries will look like in 20 years. Who knows? At the end of the day, good real estate is good real estate.” ■

US store closures rising beyond financial crisis levels as e-commerce penetration grows



Sources: Company filings, Department of Commerce, Cushman & Wakefield



## Watch list Four trends that could define the global retail property market in 2019



### Retail apocalypse?

Retailers on both sides of the Atlantic will continue to be battered by high costs, competition from e-commerce, and the debt burden many of them carry as the legacy of past leveraged buyouts. Cushman & Wakefield's head of retail research for the Americas, Garrick Brown, reckons there were some 7,500 closure announcements by major chains by the beginning of June in the US and expects the year-end figure to come in at around 12,000. "Unfortunately, I don't think the retail apocalypse story is going away any time soon."

Meyer Bergman's CEO Marcus Meijer adds: "We will continue to see middle-of-the-road retailers like Jamie Oliver's restaurants and Topshop going into administration. Brexit means the challenging environment for sales in the UK will continue and will accelerate the retail retrenchment."

### Bargain-hunters on alert

Few owners want to sell shopping centers under current market conditions, but the prospect of distressed sales is growing. "The probability is increasing that that higher-quality retail property will come to the market, which we haven't seen for almost a decade. For example, we may see that traded out of the portfolios of the listed players," says Rik Eertink, manager of CBRE Global Investors' European Shopping Centre Fund series. Moreover, managers of funds facing net outflows from mom-and-pop investors may be forced to sell to increase their cash buffers.

To date, the expectations of sellers have outstripped what buyers are willing to pay. That could soon change, says Ludovic Charpentier, head of separate accounts at AEW: "We're getting to a point where some value-add investors are waiting to call a trough in the market. The Arcadia company voluntary arrangement could be the first sign where investors say that has arrived, but everyone is afraid of catching a falling knife a bit too early."

### Retail REITs under siege

With no let-up in negative sentiment, shares in North American and European retail REITs will continue to trade at a big discount to NAV. Better-capitalized public companies may embark on share buybacks, while others will seek to secure external capital through joint ventures to improve earnings per share.

"For REITs it is very difficult," says Meijer. "As their valuations get lower, leverage levels will creep up so then they have two choices: asset sales or secondary rights offerings at big discounts. Neither one is very attractive. The best assets are still saleable but then you get left with highly levered bad assets." Many analysts tip an increase in M&A activity through consolidation and buyouts by private capital.

### Mixed-use repurposing

In July 2018, US retail REIT Macerich formed a partnership with Industrious for the co-working operator to provide serviced office space across a number of its malls. Many mall operators will look to hedge their bets and reduce excess store space by turning to other uses, predicts Brown: "The future of retail is mixed use. That is the sort of thing Brookfield has been up to since they acquired GGP last year."

CBRE's head of European retail investment Chris Gardener foresees a similar trend taking hold in Europe's big department stores. "They are often in super-prime locations because many high streets were built around them. There is a huge opportunity to unlock that real estate in the coming years."



For more on the retail market  
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## Year in retail General sector woes continue, but institutional capital still shops around for the right assets and Chinese malls are a favored target

### EQT Real Estate made its first retail real estate investment

The Swedish firm struck its first retail real estate deal as it further expands its platform in the asset class. It acquired Allee Center (pictured right), a neighborhood shopping center in Leipzig, Germany. The asset, understood to have traded for approximately €100 million, was purchased from Investa Real Estate via Colliers International. The Allee Center represents EQT's eighth investment to date and third in Germany through its debut real estate fund, EQT Real Estate I.



### Brookfield Property Partners' plans to sell an additional \$2.5bn in GGP

Having syndicated approximately \$4.2 billion of its GGP investment to various JV partners, Brookfield plans to sell another \$2.5 billion in the next one to two years. It intends to spend up to \$1 billion a year redeveloping malls in the portfolio by 2020 and eventually hopes to bring its number of malls from 125 to 100, focusing on the assets that have the best long-term outlook and redeveloping all or most into mixed-use properties. Those 100 assets would account for around 90 percent of the portfolio's value.

JUL 2018

AUG

SEP

OCT

NOV

DEC

### Sterling Organization's latest retail fund exceeded its \$450m target

The Florida-based real estate firm closed its fourth discretionary closed-end fund, Sterling Value Add Partners III. Raising \$495 million in capital commitments over 10 months, the firm exceeded its \$450 million target, challenging the notion that e-commerce has killed brick-and-mortar retail. The firm invests capital from the value-add retail fund series in most retail properties, other than enclosed malls. Fund investments will include grocery-anchored shopping centers, street retail, power centers and mixed-use properties located in densely populated areas around the US. Through its value-add fund series, Sterling looks to convert Class B properties into Class A. The firm primarily invests in broken properties or those that need to be repositioned.

### INREV: €5bn in European retail funds nearing termination

According to the European Association for Investors in Non-listed Real Estate Vehicles, there is a sizable glut of European retail property funds reaching their scheduled termination phase by 2020. The *INREV Funds Termination Study 2018* reported €5 billion of retail vehicles slated to be winding up over the period between the study's release and 2020, making up more than half the overall €9.6 billion of funds scheduled for termination during the period. However, INREV still saw reasonably consistent institutional loyalty to retail property from its *Investor Intention Surveys*: 75 percent of respondents wanted to continue investing in the asset type, down marginally from 75.9 percent in 2017.



## Blackstone's Asian retail bet bucks the data

Blackstone picked the retail sector to make the largest investment to date from its new pan-Asia core-plus real estate fund, which targets investments in high-quality Asian geographies and gateway cities. The firm agreed to acquire 50 percent of Taubman Asia's stake in three shopping centers in a deal valued at \$480 million. Two of the shopping centers are in China and one in South Korea. As of February, PERE understands the fund had raised approximately \$900 million in equity capital under management.



## Is retail tipping from 'no-go' to 'go-go'?

At the MIPIM conference in Cannes in March, some delegates said the "retail train wreck" is creating discounted opportunities across equity and debt. One manager said his firm could pursue investments in areas it had been avoiding. Possible sources of distressed assets would include owners that had bought retail properties at what they thought were cheap prices and then leveraged up those assets or UK open-ended retail funds that are receiving a lot of redemptions. But another manager called retail "the biggest danger" in private real estate investing.

## ARA to invest up to \$700m in China in 2019

Singapore's ARA Asset Management is tapping the vast pools of domestic Chinese capital with its latest onshore strategy, understood to be the first time the manager is raising yuan capital from mainland Chinese institutions for domestic real estate investment. The firm has two to three deals in the pipeline to put capital to work. The first has been announced – a 50:50 joint venture with Beijing-based investment manager CICC Capital to purchase a commercial mall in Chengdu, one of China's fastest growing cities.

JAN 2019

FEB

MAR

APR

MAY

## US private equity sizes up UK retail parks

Investors in real estate funds sponsored by US opportunistic managers should not be surprised if US managers soon get stuck into portfolios of UK retail parks. "Suddenly, private equity came in swinging in the past three months," one broker said in April, adding that several US managers he had met with in previous months had bid on retail parks. Initial interest was prompted in part by UK REIT Hammerson's decision to sell its retail parks and the potential scale of the buying opportunity. The company sold nine such assets for a total of £564 million (\$733 million; €652 million) from 2016-18 and has 13 remaining properties worth an aggregate £900 million. About a dozen other retail REITs and UK funds are seeking to shed retail warehouses, according to a broker. But while US managers have been making offers, they have yet to pick up assets.

## Retail in the mix in Brookfield's biggest ever China investment

Brookfield announced it would purchase a 13.9 billion yuan (\$2.1 billion; €1.8 billion) mixed-use complex in Shanghai from Chinese developer Greenland, which includes three office towers and a lifestyle retail mall at Greenland Huangpu Centre (GHC) totaling an area of 166.3 million square feet. According to JLL, the average cap rates of shopping malls in Shanghai are around 4.4 percent. The firm expects the mall to open in mid-2020. Head of China real estate Stuart Mercier said he believes the firm's large global retail portfolio and experience will give it an edge in China. Last year, it added two malls in Shanghai to its global portfolio – The Mall Jinqiao and The Mall Nanxiang. Those acquisitions gave the firm the local team and experience to run the lifestyle mall in GHC.

170

Properties in Brookfield's global retail portfolio post-GGP acquisition

50%

Blackstone's stake in three Asia shopping centers after acquiring Taubman Asia

\$495m

Capital raised for Sterling Organization's value-add retail fund

## Editor's letter

# A retail 'apocalypse' or revival?



**Helen Lewer**

[helen.l@peimedia.com](mailto:helen.l@peimedia.com)

If capital allocation decisions were based on news headlines, investors would be wise to leave retail property well alone and send their money elsewhere. Such is the sensationalist coverage we are exposed to predicting the demise of brick-and-mortar stores. Market practitioners in the UK were sent into a spin of late when two stalwarts of the British high street, Marks & Spencer and Boots, the pharmacy chain, announced plans to close more than 300 stores between them. The sector's image is no better in the US, where ghost-town suburban mega malls have become a familiar sight.

So for managers, a retail fund is likely to be difficult to pitch to cautious investors that are uncertain of the direction in which the sector is heading. And *PERE* fundraising data shine a light on this: as at the end of Q1 2019, just \$9.5 billion was targeting retail-focused funds in market. Compare that with the \$31.45 billion for residential-focused funds. And no retail funds closed in the first quarter.

Retail property is just too risky a bet, it seems. But maybe it is time to reassess that notion. For within these pages more upbeat tales are also told: of a sector rebirth as creative retailers begin to adapt to modern consumer demands. Far from e-commerce cannibalizing brick-and-mortar retail, many retailers are actively pursuing both a digital and physical presence. And new tenant types – health and wellness centers, for instance – are starting to occupy the vacant units left behind by traditional retailers that have downsized, or gone bust, through their failure to evolve their business models.

For current owners of retail real estate, this should be music to their ears. And for investors thus far reluctant to dip their toes in the asset class, perhaps now is the time to give it a look. Opportunity, it seems, is there for the taking, and fortune favors the brave.

Enjoy the report.

**Helen Lewer**

**“Retail is too risky a bet, it seems. But maybe it is time to reassess that notion”**



### New York

130 West 42nd Street  
Suite 450  
New York  
NY 10036  
T: +1 212 633 1919

### London

100 Wood Street  
London  
EC2V 7AN  
T: +44 20 7566 5444

### Hong Kong

19F On Hing Building  
1 On Hing Terrace Central  
Hong Kong  
T: +852 2153 3240

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# Have rumors of retail's death been greatly exaggerated?

*US retail property funds are attracting interest from institutional investors, despite negative sentiment in the sector, reports **Lisa Fu***

**B**ack in August 2018, North Carolina-based real estate firm Asana Partners launched its second value-add retail fund, Asana Partners Fund II. When the fund held its final close in April this year, it was oversubscribed to the tune of \$800 million, with commitments from institutions including the Los Angeles City Employees' Retirement System, New Mexico State Investment Council and the South Carolina Retirement System.

The interest in Asana Partners Fund II was likely driven by a perceived overcorrection in retail property prices relative to other property types, according to Marcus & Millichap senior vice-president and national director of retail Scott Holmes.

Prices have come down enough that investment returns on retail properties are looking attractive again, especially compared with other fully priced property types, notes Holmes.

US retail property prices have fallen approximately 15 percent from October 2016 to April 2019, according to research and advisory firm Green Street Advisors' Commercial Property Price Index. In comparison, industrial and multifamily property index values increased 25 percent and 6 percent, respectively, during the same period.

Though some retail properties like fortress-style malls continue to struggle and many large institutional investors are keen

*“The fundraising environment for retail is probably not as challenging as one might think”*

**ADAM MUNDER**  
Sterling Organization

to keep allocations to retail low, the market conditions for retail real estate are stronger than the headlines would lead you to believe, argues Holmes.

Construction remained low following the financial crisis, limiting the supply of new retail real estate. And vacancies left by some failing retailers are quickly being filled by more successful stores looking to expand. Retail properties as a whole in the US are around 95 percent occupied, Holmes says, which is similar to industrial and apartment occupancies nationally.

Speaking generally on retail real estate fundraising, Nancy Lashine, managing partner and founder at placement agency Park Madison Partners, believes investor interest in retail strategies is likely more nuanced. Many investors found their portfolios under-allocated to retail after focusing heavily on the multifamily or logistics real estate sectors for many years, which could be driving capital commitments to retail strategies. There just have not been many opportunities to invest in retail-specific funds over the last few years, and investors that wanted retail exposure were limited to diversified funds or investment products on the public market, according to Lashine.

Indeed, the number of US retail-specific closed-ended fundraises hit a high in 2013 and 2014, with eight funds closing during both years, according to PERE data. In 2015, only three funds closed, with the number of total closes having remained at

five or below since then. Not all retail property investments are equal and many investors still find the sector attractive, according to Adam Munder, principal and chief marketing officer at Sterling Organization. The firm raised \$495 million for its fourth value-add fund last year, surpassing its \$450 million target within 10 months.

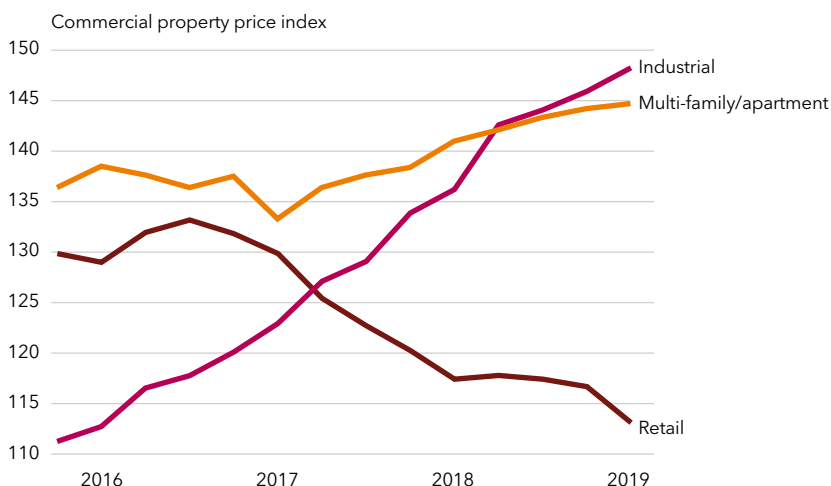
Some investors in the fund doubled their commitments from the previous fund, feeling that this was the moment for a contrarian play, explains Munder. “We’ve seen more of the contrarian investors in the last 12 months coming in and saying, ‘[The retail apocalypse] has been so overblown.’ The fundraising environment for retail is probably not as challenging as one might think.”

### Quality matters

Despite doom and gloom headlines about the death of brick-and-mortar retail properties, Munder still sees many opportunities, especially around grocery-anchored retail. Finding assets trending below market rents and not compromising on quality or the quality of location is key, he believes, and contrary to market sentiment, when excluding enclosed malls, retail property vacancy is down and rents have been rising over the last five years.

The lack of retail funds on the market has worked in Sterling Organization’s favor. Over the last few years, Munder has observed a decrease in the number of private real estate funds pursuing a US retail strategy. Only a handful of firms have retail-specific funds, and diversified funds in market are typically underweight retail, resulting in less competition for retail property acquisitions.

Retail property prices are down 15% since October 2016 (Indexed to 100 in August 2007)



Source: Green Street Advisors

Though Lashine anticipates more bankruptcies from retailers, she also sees opportunities emerging from the sector’s challenges. The retail property sector is attractive because it is one of the few areas that offers distressed opportunities, but she warns that simply buying cheap product is a fool’s errand.

Brookfield Property Partners chief executive Brian Kingston agrees with Lashine’s sentiment noting that there is a large gap in the market between high-quality and lower-quality retail assets. “Retail isn’t overbuilt, it’s under demolished,” says Kingston, who also holds the opinion that the story around the ‘retail apocalypse’ is overblown and does not apply to high-quality retail properties with the right tenant mix.

While plenty of traditional retail tenants have struggled, those that quickly built out an omnichannel that mixes online sales and in-store sales are succeeding. These successful tenants will want the highest quality properties in good locations that pull in foot traffic, he says.

Those that pursue retail property investments need to curate the tenants, according to Kingston. An office landlord is mildly interested in the tenants’ businesses, but creditworthiness takes center stage. A retail landlord, however, needs to act as a partner to retail tenants by creating the right environment to attract customers.

Lashine, who has been searching for the right retail investment product to take to market for the last two years, explains that investors want to see operating expertise and an ability to rework the tenancy, and concludes that managers need to understand customers, who the right tenants are and whether the tenants can afford to occupy the space.

A few other retail funds have held successful closes in the recent past. One of the most notable was Meyer Bergman in February last year, breaking its fundraising record with a €816 million close for its third fund. This, and the successful fundraises by Asana Partners and Sterling Organization, indicate that at least some investors have faith in the property type regardless of wider market concerns that e-commerce is eroding brick-and-mortar sales. ■



Browsing the market: investors should look for quality assets



## EXPERT COMMENTARY

*The US retail sector's fundamentals in early 2019 are holding their own with operators and tenants getting more creative with the use of brick and mortar; writes Yardi's **Chris Barbier**, principal, investment management*



# A 'stubbornly' resilient asset class

"Online shopping officially overtakes brick-and-mortar retail for the first time ever." That eyebrow-raising headline appeared briefly on CNBC's website on April 2, although it was later amended. But the fact that it initially seemed plausible is a sign of the perceptions swirling around the retail sector and retail real estate.

Retail presents the most complex and even contradictory currents of all the major commercial real estate asset categories. In no small part, this complexity stems from the diversity of a sector that encompasses properties ranging in size from 1,000-square-foot quick-service restaurants to million-square-foot regional malls, and everything in between. So attempting to paint the entire asset class with a single broad brush is a perilous exercise, yet one trend is clear

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– faced with a full menu of challenges and despite the eagerness in some quarters to write an epitaph for brick-and-mortar retail, the asset category is proving to be stubbornly resilient.

Retail operators are investing in bold redevelopment programs and exploring new technology while healthcare providers, co-working spaces and other non-traditional retail tenants are discovering attractive locations at retail centers, backfilling vacant space and helping drive foot traffic to fellow retail tenants.

Certainly, investors started 2019 with a cautious approach to retail property assets.

The pool of big-ticket buyers is dwindling and institutional investor acquisitions dipped 7.8 percent during the first quarter, according to JLL estimates in May. One notable exception was the best first quarter for power center deals since 2016, the result of a 30.4 percent year-over-year surge in volume. In another major shift, institutional investors are also turning their attention from large portfolios to deals under \$100 million. Despite store closures and competition from online sales, vacancy is holding steady at 3.6 percent for malls and 4.4 percent overall, according to JLL data. While absorption was down 61.9 percent, the decline was offset by a 24 percent drop in new retail space, JLL reported.

Multi-tenant vacancy is also on track to decline in 2019, with net store openings

outnumbering store closures, according to Marcus & Millichap. In contrast to the overbuilding characteristic of the period leading up to the Great Recession, developers have kept supply in check by maintaining discipline; just 10 markets will account for half of new product completions this year. Secondary and tertiary markets may be attractive to investors looking for yield as a limited supply of new retail inventory in those locations is fueling demand, creating opportunities to buy assets at a relatively low cost of capital and with higher potential returns, according to Marcus & Millichap. Successful investors, owners and retailers will continue to embrace and understand the “five Fs of retail” that are now thriving: food, fitness, fashion, furniture and fun.

The backdrop to the retail investment picture is an economy that continues to hum along on the strength of low unemployment, consumer confidence and rising wages. The National Retail Federation estimates that US retail sales will rise from \$3.68 trillion in 2018 to \$3.9 trillion this year. That is helping maintain momentum in the face of events that would have stalled the retail sector in a weaker economy: a 0.08 percent drop in consumer spending last December; the 35-day partial shutdown of the federal government, which took an \$11 billion toll on the economy; and extreme weather, particularly in the nation’s heartland, that combined with a soft housing market to hamper sales of home-related products such as furniture, appliances and building materials.

*“Successful investors, owners and retailers will continue to embrace and understand the ‘five Fs of retail’: food, fitness, fashion, furniture and fun”*

**CHRIS BARBIER**  
Yardi

### Multichannel trends

No aspect of the retail sector calls for more careful analysis than the interaction of online and brick-and-mortar channels. If you judged the retail sector exclusively by media headlines, one might conclude that online sales account for the majority of consumer retail spending. The convenience of online shopping has undoubtedly contributed to hard times for well-known brick-and-mortar brands specializing in products like apparel and consumer electronics, yet sophisticated retailers, whether native online or

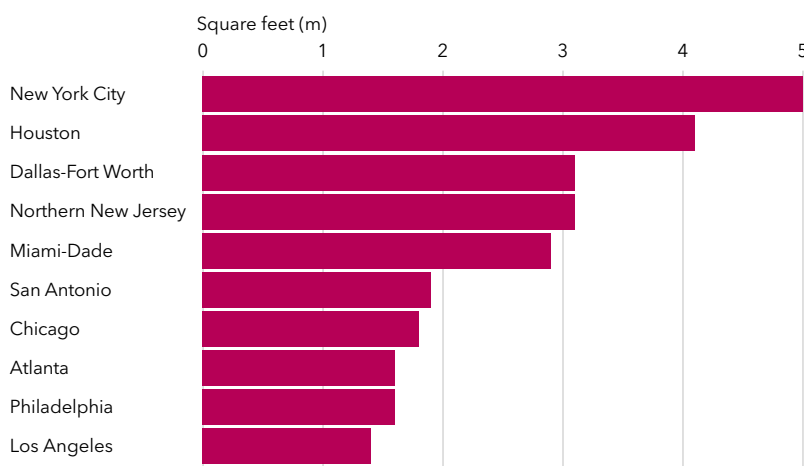
brick-and-mortar, are embracing the value of multichannel marketing. Online sales continue to take a growing share of the retail market, yet represent just 10 percent of actual retail sales. And in a consequential trend for property operators, native online retailers continue to expand to brick-and-mortar formats, creating a steady, if relatively modest, demand for space. Nearly all of the top 50 online retailers now maintain physical stores.

The brick-and-mortar ambitions of Amazon, which accounts for almost half of US e-commerce sales, underscore the point. According to a March report in the *Wall Street Journal*, the company is eyeing plans for an empire of some 2,000 Amazon-branded grocery stores. Presumably those properties would complement, rather than compete with, the 500-store Whole Foods chain acquired by Amazon for \$13.7 billion in 2017. The first store would open this fall in Los Angeles, followed by stores in Chicago, Philadelphia, San Francisco, Seattle and Washington, DC, the *Journal* reported.

Absent details, the impact of Amazon’s rumored intentions to expand its grocery-market footprint are nearly impossible to assess. Nevertheless, a long-term rollout on that scale would likely affect the dynamics of fundamentals of grocery-anchored centers. As the early post-recession years demonstrated, properties anchored by necessity retail, like grocery stores, provide stability and reliable returns through economic fluctuations.

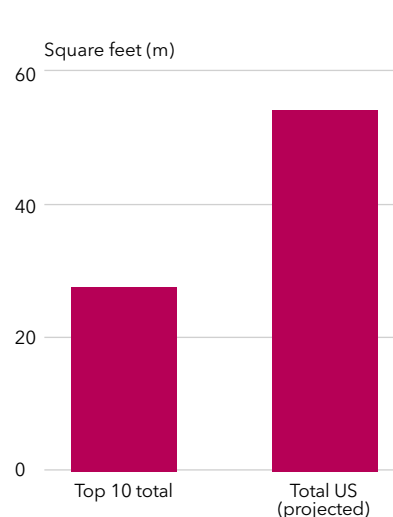
The continued waves of large-scale store

Top 10 US markets for new retail completions



Source: Marcus & Millichap, 2019 Retail North American Investment Forecast

How they compare: Top 10 vs the US





Fresh retail approach: Nordstrom Local provides add-on services like tailoring to attract customers

closings unquestionably pose challenges to operators and concerns for investors. As of early June, retailers had announced plans to close 7,222 stores and open 2,796, according to Coresight Research. Announced closings could reach 12,000 this year, the firm estimates. By contrast, Coresight tracked 5,864 closures and 3,239 openings for all of 2018. Leading this year's list of downsized or disappearing brands are Payless Shoes (2,500 store closings), Gymboree (805) and Dress Barn (650). The closings are variously attributable to online competition, excessive debt assumed during leveraged buyouts and the failure of retailers' leadership to keep up with the times.

What tends to get overlooked is the other side of the equation. The National Retail Federation's annual survey found 54 percent of retailers plan to open new stores in 2019, while 57 percent expect to end the year with about the same number of stores they started with. Retail saturation is also a consideration for investors, developers and retailers themselves. It is a truism that the US has too many brick-and-mortar stores; Daniel Hurwitz, CEO of Raider Hill Advisors and 2019-20 chairman of the International Council of Shopping Centers, has quipped, "We're not over-retailed – we're under-demolished."

While Hurwitz has a point, distinctions among markets suggest opportunities as well as cautionary notes. To pinpoint the most and least over-retailed metropolitan areas, Reis, the real estate data and analytics company, compared retail employment to population on a market-by-market basis. Topping the over-retailed list: Orlando, Lexington, Jacksonville, Fort Lauderdale

and Knoxville. Ranking as the five least over-retailed markets are Tucson, Providence, San Bernardino/Riverside, New Haven and Washington, DC. Rent appreciation appears to track saturation levels, with over-retailed markets demonstrating considerably slower price growth than their less over-retailed counterparts. One perhaps surprising conclusion of Reis' assessment is that saturation may be less troublesome than expected, in part because unconventional tenants like urgent care facilities and yoga studios often absorb vacant retail space.

## Consolidation with a caveat

As property owners grapple to adapt to change at ground level, realignment continues at the corporate level. Last year, Brookfield Asset Management completed a pair of blockbuster deals: the \$27.2 billion acquisition of GGP and the \$11.4 billion purchase of Forest City Realty Trust. Multiple retail property operators, whether strong or struggling, could well be courted successfully; in its 2019 Real Estate M&A Outlook, Deloitte projects further consolidation, led by the retail and lodging sectors. One caveat, Deloitte adds, is that all real estate categories, including retail, are likely to experience one or more market disruptions that could influence the volume and value of M&A activity.

Retail REITs continue to enjoy record-breaking fundamentals, with REIT-owned retail properties reaching 95.43 percent occupancy, the highest on record since tracking began in the first quarter of 2000, according to NAREIT.

Even as some regional malls have sputtered, and often shuttered space, owners

continue experimenting with new combinations of services. At The Mall at Short Hills, an upscale property in Short Hills, New Jersey, Taubman will introduce a co-working space in a 30,000-square-foot outpost previously occupied by Saks Fifth Avenue. Macerich is similarly partnering with Industrious, a New York City-based provider of flexible office space, to open co-working space at the REIT's properties. Debuting in January 2019 at Scottsdale Fashion Plaza in Scottsdale, Arizona, the program's forthcoming locations will include Macerich's Broadway Plaza in Walnut Creek, California. A study by Colliers International cites co-working as a potential driver of foot traffic at retail properties: "More than two-thirds of people say that a co-working space located in a mall would encourage them to visit shops more often; for restaurants, the figure is 73 percent."

Venerable retailers are freshening up their approaches as well. Since October 2017, Nordstrom has unveiled three small locations in upscale Los Angeles submarkets. Conventional apparel inventory is conspicuously absent from the stores, which are branded as Nordstrom Local. Instead, each store aims to build customer loyalty by offering services such as alterations, styling and pick-up of online orders. The retailer reports Nordstrom Local patrons tend to be younger, shop more often and spend more than customers who do not visit these stores.

This fall, Nordstrom will bring the concept to Manhattan's Upper East Side and West Village, around the same time as a 320,000 square foot flagship store opens in Midtown Manhattan.

Another retailer defying traditional retail logic is Rent the Runway, which has opened a new 8,300 square foot flagship in San Francisco's Union Square. Instead of selling product directly, Rent the Runway features a self-service counter, 3,000 curated merchandise items, event space, co-working space, a beauty bar and 20 dressing rooms.

Retail real estate investment in the US presents investors with a constantly changing set of variables. For investors in search of yield, unconventional but promising metros deserve a close look. So do the retailers and operators dedicated to innovative technology, tenant line-ups and property configuration. Some industry veterans speculate that the future of larger retail properties is mixed use. Not all experiments will succeed, but the future favors operators and retailers willing to make bold choices. ■



# US retail's vital signs are looking good again



Guest comment by **Bryan Ley**

## *HFF's managing director tells us where investors can find value in 2019*

Investors are always asking where the opportunity is in US retail. Most start with the sectors that have been heavily discounted due to vacancy or tenant bankruptcies, or areas that command a higher return today. And those areas are power centers and grocery-anchored neighborhood centers in suburban submarkets.

The power center space has become a tremendous buy opportunity for value-add investors, generating double-digit cash-on-cash returns. This space was hit hard during the large tenant bankruptcy years of 2015-17, so some property values declined 10-30 percent. Investors were a little shy to enter the space. Fast forward to 2018-19, and this space is now experiencing tenant expansion. Those vacant boxes in centers from previous bankrupt tenants are now presenting value creation opportunities for the next owner.

### **Grocery shopping**

The closure of tenants like Toys 'R' Us presents many owners with opportunities to lease those boxes at higher rents, or better yet, leasing those spaces to grocery tenants. This is important to investors; adding a grocery anchor creates more daily trips to the center and presents new merchandizing options, with other tenants desiring to lease space at a rebranded center. And that could result in higher pricing when an owner decides to sell.

According to Real Capital Analytics, grocery-anchored centers accounted for more than \$9.9 billion of transaction volume

in 2018 across the US. For the grocery-anchored neighborhood centers in suburban submarkets, pricing is typically not as rich as in urban centers, so there is less competition from the investment community. This offers a good buy opportunity for investors, as these suburban markets are just outside the core trade areas and in the neighborhoods where people live, raise families and typically have more disposable income.

According to NCREIF, the markets that saw the highest total returns for retail included cities like Nashville, Orlando, Anaheim and Riverside in California, Plano, Texas and Columbia, South Carolina. These

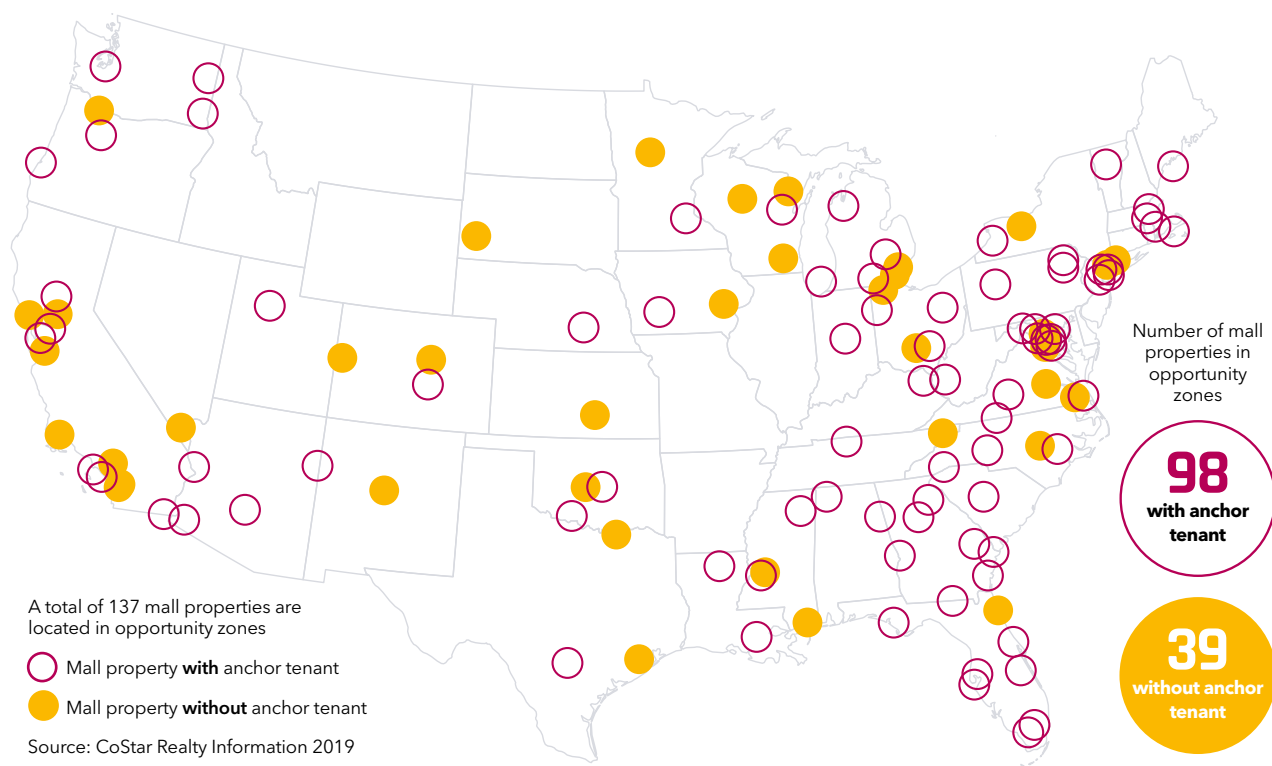
suburban submarkets saw the highest compounded annual return growth for investors and strong job growth, which increased incomes and the disposable income available in these markets. That, in turn, generated retail growth, tenants posting stronger sales volumes and owners able to charge higher rents. Demographics are important for any investor or tenant to follow, as average household income and daytime population are two vital metrics when looking at whether or not a trade area can support retail and rent growth.

JLL Research showed there was a 30 percent increase from 2017 to 2018 in grocery store openings in the US. This increase saw many grocery stores enter not only urban trade areas but suburban and secondary markets and, as mentioned, even the power center space. More than 17 million square feet of space was leased in 2018 to grocery tenants, according to JLL Research, and 25 percent of that square footage was leased in California, Florida and Texas. Grocers that are expanding include Aldi, which has plans to open 800 additional stores over the next five years, and Sprouts, which is averaging 30 store openings per year. Another strong growth grocer is Trader Joes, which continues to expand eastward and is planning 30 to 35 stores across the US.

The grocery sector is here to stay; it is a daily needs retailer that keeps customers coming back to neighborhood centers for their essentials and it serves as a dominant anchor tenant in these property assets. ■

### Key takeaways

- Well-located retail assets in strong markets will always have better opportunities for tenancy, rent growth and income growth.
- Suburban submarkets are showing some of the best retail rental growth. There is less investor competition and pricing is usually less than in urban core markets.
- Stay focused on demographic drivers and daily needs tenancy. The ability to add a grocery store will improve overall asset value.



## Opportunity shops

*A federal investment program can breathe new life into America's struggling malls and shops, but for only a select few, writes **Kyle Campbell***

**T**he demise of American retail has been well documented by real estate professionals and amateur observers alike. One blog has a running tally of more than 450 dead or dying malls across the country and social media accounts abound with dystopian images of vacant sites succumbing to the elements.

Yet, one man's photo fodder may be another's tax haven thanks to a lucrative set of federal investment incentives. Created in late 2017, the qualified opportunity zones program allows investors to avoid paying taxes on capital gains by rolling them into assets in certain distressed areas. Some hopeful participants view the nation's many

troubled retail properties as prime opportunities in waiting.

There are 137 regional and super regional malls within the 8,600-plus designated opportunity zones, according to CoStar, a data and analytics firm. Collectively, those properties account for more than 7,200 acres – more than 11 square miles – of land that can be redeveloped for tax-free profits. Additionally, there are numerous freestanding big-box sites shuttered by the collapse of retailers such as Toys 'R' Us and Sears, which owned 284 and 425 stores, respectively.

Retail vacancy has crept up in recent years as the rise of e-commerce and shifting demographics disrupt the market. Regional and super regional mall vacancy has risen

from a steady average of less than 8 percent in 2016 to more than 9 percent by the end of 2018, according to Reis, the real estate analytics arm of Moody's. Neighborhood and community centers – home to supermarkets, drug stores and discount retailers – have fared worse, with more than 10 percent of their spaces remaining unoccupied.

Investment professionals familiar with the opportunity zones program tell *PERE* it will be a valuable tool for raising capital to revitalize some struggling retail properties or even reposition them for new uses. Some developers are seeking to convert these complexes into mixed-use residential communities while others would replace them with warehouses for last-mile distribution.

"The fact of the matter is the incentives that exist by virtue of the opportunity zone legislation could materially enhance returns in the opportunity zone districts," says Todd Henderson, head of real estate for the Americas at DWS Group, a German asset manager. "As a result, I think you will see investors willing to take more risk and try to redevelop some of these dark malls that are suffering from the shift of retail sales away from bricks and mortar to e-commerce."

However, Craig Bernstein, principal and chief investment officer of OPZ Bernstein, an opportunity zones-focused manager, warns that pitfalls could await imprudent investors and the program should be viewed only as an added incentive, not a cure-all.

"The opportunity zones program has the ability to make a good deal great, but it won't make a bad deal good," Bernstein says. "At the end of the day, the deal still needs to stand irrespective of the tax benefits. You can't, under any circumstances, let the tail wag the dog."

Investors can receive a 15 percent reduction in the taxable basis for their capital gains if they roll them into qualified opportunity funds by December 31. Phillip Marra, national audit leader for KPMG's US building, construction and real estate practice, says other benefits can be had even if that deadline is missed, so investors need not make hasty decisions. A 10 percent basis step up is available for investments made before 2022 and gains from opportunity zone investments held for 10 years or more can be realized tax free.

### Unique challenges

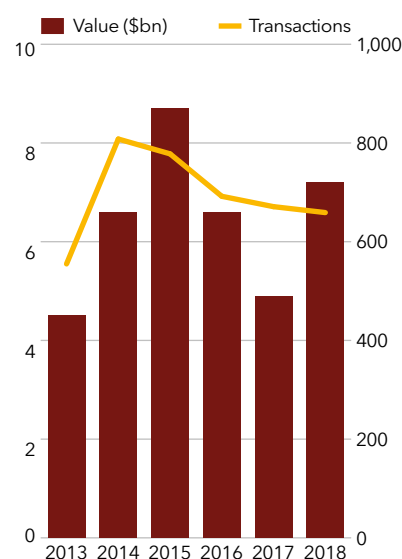
Finding suitable retail properties is a challenge in itself. Of the 137 malls in opportunity zones, 39 are without an anchor tenant, indicating significant distress. While other centers are reliant on shaky tenants – such as the two dozen malls anchored by JCPenney department stores – anything that increases the value of a property adds burden to opportunity zone investors. The legislation's substantial improvement clause requires investors to double the value of adaptive reuses. This only applies to the non-land value of the real estate, meaning if a building is bought for \$1 million and \$200,000 of that cost is land value, the buyer must spend an additional \$800,000 toward improvements.

An original use provision allows investors to avoid the substantial improvement requirement, but it applies only to unde-

*"The opportunity zones program has the ability to make a good deal great, but it won't make a bad deal good"*

**CRAIG BERNSTEIN**  
OPZ Bernstein

The number of retail transactions is falling in areas now defined as opportunity zones



Source: Real Capital Analytics

veloped land or buildings that have been vacant for at least five years. Some defunct malls meet the latter criteria, but the best-positioned of those properties have already been taken off the market. Amazon, for example, has acquired two former mall sites in suburban Cleveland to build fulfillment centers and is reportedly aiming to do the same at a property in nearby Akron, Ohio – all three are in opportunity zones but it is unclear if the company will make use of the program's benefits.

Retail transaction volumes in opportunity zones increased substantially after the initiative was signed into law as part of the Tax Cuts and Jobs Act, going from \$4.9 billion in 2017 to \$7.2 billion in 2018, according to

data provider Real Capital Analytics. Twelve fewer properties traded hands last year compared to the year prior, but the average sale price rose by nearly \$4 million.

High costs may prevent some opportunity zone investors from acquiring whole retail complexes, but Marra says a more measured approach may be to purchase individual buildings or parcels of land. A big box apparel store might be bought and retro-fitted for medical offices, he suggests, or a swathe of an unused parking lot could be parceled off and sold for new development.

### Limitations and restrictions

Converting a mall site to another use is also easier said than done. Local zoning may prohibit housing developments or neighbors could push back against traffic-heavy uses such as distribution warehousing. In anticipation of such hold-ups, a recent regulatory addendum allows additional time for capital deployment for projects delayed by local government inaction.

For investors that want to retain their properties' retail use, the opportunity zones legislation does impose some limitations. Owners are not able to sign traditional triple-net leases with their tenants because of equity requirements in the law. Landlords must continue to operate at least some part of the property, Bernstein says, even if it is just the parking lot.

While investors can also use capital gains to seed startup businesses within opportunity zones, much attention has focused on real estate in the early days of the program. NES Financial, a San Jose, California-based financial services firm, has been approached to handle fund administration for more than 220 opportunity zone investment vehicles and roughly 80 percent of them are focused on real estate, Reid Thomas, the group's executive vice-president and general manager, says.

However, only about 5 percent of those deals had a retail component. Bernstein has seen similar limited interest in retail, owing to uncertainties surrounding the property type and the strong demand for multifamily and industrial assets.

Ultimately, defunct malls and under-occupied shopping centers will be just a piece of the opportunity zones puzzle, but as the details of the program come into greater focus, it seems distressed retail in the US provides too large an opportunity to be ignored. ■



# What is the right price to buy retail property?



Guest comment by **Bill Schwab**

*In uncertain times for the sector, this is the question preying on investors' minds. Real Estate Investments' principal and the former global head of real estate at ADIA offers an answer*

To buy or not to buy retail? That is the question. Or to frame it differently: What is the price at which investors should buy a particular retail property? Being able to solve this puzzle is ever more critical as changing business models, shifting competitive advantages, and emerging proptech and fintech technologies are all poised to further disrupt the retail industry and retail property valuations.

Given the current uncertainty in the retail market, a good way to start is to derive a range of values for a particular property from the lowest price, reflecting reasonably pessimistic performance assumptions, to the highest price, driven by optimistic assumptions. This will generate a range of relevant prices for a prospective investor to consider allowing them to zero-in on what is a reasonable price to pay for a retail asset. As a rule, anything priced at or below an asset's minimum value is going to be an interesting investment proposition. The more pressing question for investors is how to value a retail asset that is not obviously dominant retail and is not expected to remain retail given its highest and best alternative use (HBAU). Let's focus on assets of that nature.

Two factors contribute to making a property asset valuable specifically for retail use: its catchment area and surrounding infrastructure; and its physical structure and tenancies. Both elements are valued in relation to competitive properties. The more densely populated, wealthier and

faster growing the catchment area, the more valuable any property within it will be for a purely retail-focused use. The better the infrastructure – transport network, telecommunications connections and utility provisions – the greater the retail potential

of the asset. But these same characteristics also make a property valuable for non-retail or alternative usage. And an investor can determine their worst-case scenario price for a retail property by estimating its HBAU value in non-retail use. In a strong catchment and infrastructure location, office, logistics, residential, hospitality and other uses can have significant value.

Once the HBAU alternative use and location value of an asset are determined, it can be added to the estimated incremental retail use value (expected income stream from retail usage over the hold term – the term itself another parameter to be estimated) to develop a minimum value – or price – to potential investors. Any asset priced in markets at or below that minimum value is likely to be an interesting investment opportunity.

Let us determine an investor's value for an asset priced by the market at \$100 million. Let's say 80 percent of the retail price can be recovered in an alternative use for the property (the residual value/location value of the property), perhaps this is under a residential usage. The residual value or HBAU is highly probable – by definition it is estimated as such under the price-to-worst scenario – and it can be discounted back from the point in the analysis at which the property's use is converted to its HBAU at a low discount rate reflecting that high probability, say 7 percent. This leaves 20 percent of the price in the retail structure and its tenancies – its incremental retail usage value.

*“The more densely populated, wealthier and faster growing the catchment area, the more valuable any property within it will be for a purely retail-focused use”*

## How long to invest

So, how does the investor estimate the term of the investment for which the property should continue in retail use? From what point in time should incremental retail use value be discounted back in order to determine its contribution to current value for an investor or how long should the retail rent be modeled to contribute to its estimated minimum value? Under this approach, an investor can tranche retail income by confidence levels or certainty bands.

For example, an investor may feel:

- Confident that the majority of current retail income is sustainable over a short term (say 80 percent of in-place rent for five years);
- Some confidence that the rest of the in-place rent is sustainable for eight years (20 percent for years one to five and 100 percent of the in-place rent for three more years);
- Low confidence for another two years of 100 percent of the in-place rent;

- An unwillingness to ascribe value to the in-place rent beyond 10 years.

The investor could discount their rent expectations as:

- 80 percent of rent for five years at 7 percent – high confidence;
- 20 percent for years one to five and 100 percent for years six to seven at 11 percent – some confidence;
- 100 percent for years nine to 10 at 15 percent – low confidence;
- 0 percent thereafter – very low confidence.

The final step of the approach is to decide which year to terminate the analysis? By combining the discounted value of HBAU with the discounted value of rent over a set of scenarios – year by year – an investor can develop a view as to their expected hold period and how to estimate the minimum value of the investment to themselves. The hold period should be the year that maximizes the total value of the investment in the hands of the investor. Sensitizing the various

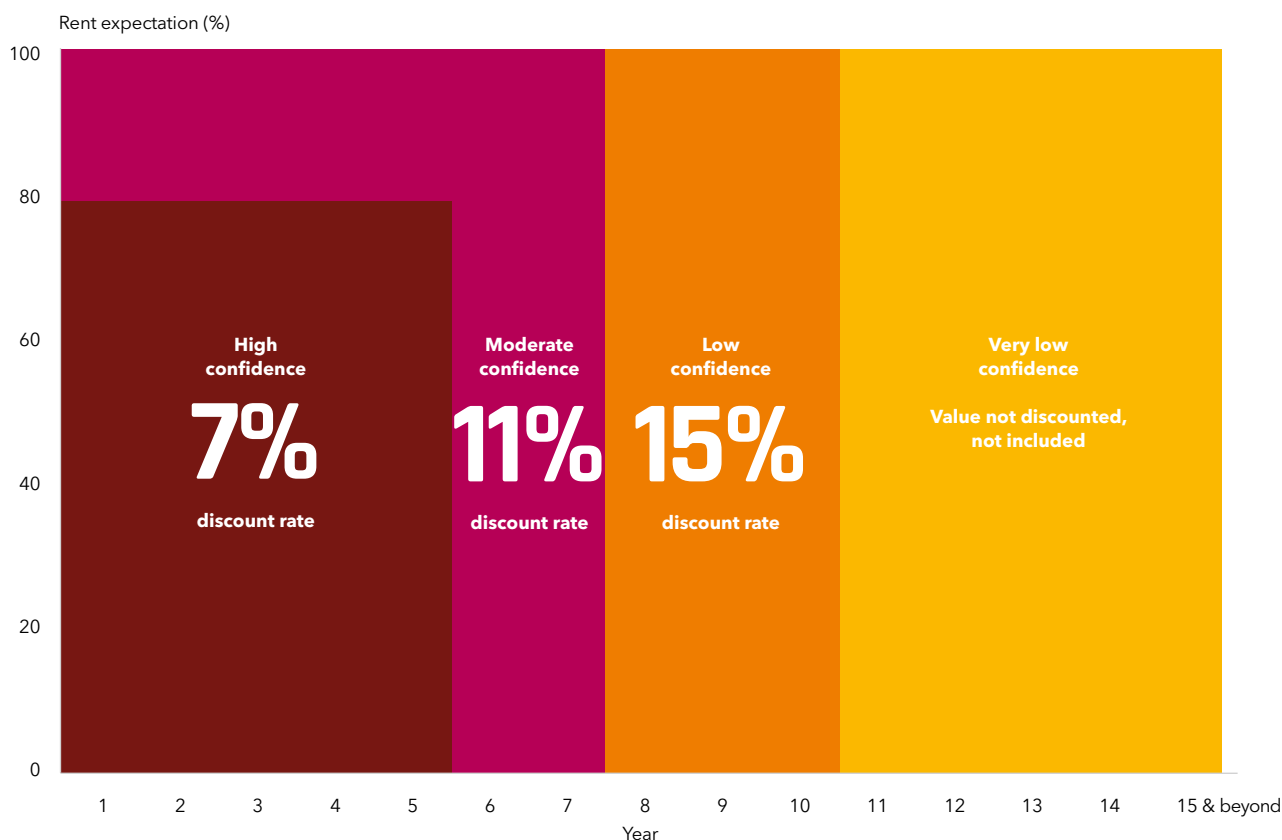
elements of the analysis allows the investor to consider how optimistic they wish to be regarding pricing for the property over and above its calculated minimum value.

This approach allows an investor to think in a structured way about their views on the:

- Level of confidence in an asset's location/residual value (HBAU) versus its current usage;
- Expected value of its retail income stream as to levels, term and probability;
- Optimum year to convert from retail usage.

Retail assets may be an attractive investment if you believe in high alternative use value and a reasonable period of time during which you can expect to collect in place retail rents. To make your pricing decision with regards to investing into a retail property, it helps to have a valuation model that allows separate consideration of each major element of that pricing decision and sensitize your price analysis accordingly. ■

Retail discount analysis: confidence levels in achieving income from a property's retail use



Source: The author

## KEYNOTE INTERVIEW

# Where to find value in European retail



*Attractive risk-adjusted returns are still available in European retail real estate if investors can see through negative sentiment and select the right assets, argues Savills Investment Management's **Kiran Patel***

In May, once-dominant British fashion business Arcadia recently became the latest in a string of high-profile European retailers to run into trouble, putting 18,000 jobs at risk. The widespread perception that many other shopping chains are in a similarly precarious condition has dampened investor enthusiasm for retail real estate. However, Kiran Patel, global CIO and acting global CEO at Savills Investment Management, tells *PERE*'s Stuart Watson that opportunities remain in the sector for investors prepared to shut their ears to the mood music surrounding it, and look closely at the performance of individual assets.

**Q Are conditions for European retailers as tough as the news headlines suggest?**

Retailers entering into company voluntary

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arrangement (CVA) insolvency proceedings are, and will be, an almost daily occurrence in the UK. Until the cost issues facing retailers are resolved, the UK in particular is going to see a decline. Those issues have arisen not just because rents are too high, but business taxation, employee and regulatory costs have also increased. Given these trends, together with the fact that the UK has too much retail space, there has to be consolidation.

Some European countries have tighter planning laws, which have provided more protection against new supply, so there has not been the same proliferation of space everywhere. Lease structures also vary. In

the UK leases are very landlord-friendly, while in continental Europe they favor the tenant more. The economic costs required to make a retailer's business viable when operating out of a particular unit have to be in balance, and those costs are a lot higher in the UK. Meanwhile, physical retailing across Europe has suffered from the growth of e-commerce, and not only is the UK more advanced in terms of the uptake of online retailing than most continental markets, but the impact of that trend is greater because the cost of doing business is higher.

E-commerce is not just a one-way bet, though. There is talk of the European Commission introducing a 3 percent online sales tax in 2020 to try to level the playing field, and online retailers spend a lot of money funding free delivery and returns. Few

retailers anywhere in Europe can survive as pure bricks-and-mortar operations though. Many are developing e-commerce attachments to their offers.

The beauty of bricks-and-mortar shopping is that where tenants are on turnover leases you can get much more detailed information about how your tenants are operating than you would be able to managing office or industrial property. That allows you to identify properties with positive trends that you do not mind buying into. Demand for physical retail is not dead. It is not rising as fast as e-commerce sales, but it is still growing. Managers need to acquire assets that are resilient to the cost pressures and e-commerce trends facing retailers.

### Q How has that difficult environment affected investor attitudes to the sector?

Retail is a hard sell at the moment. The headlines in the UK and US are dominated by retailers going bankrupt and shutting stores, but they do not tell you about the retailers that are doing well and the shops that are opening. That creates an image that stigmatizes the sector. It is easy for investment boards to treat retail as a pariah at the moment, and not touch it under any circumstances.

Some tell us that even though they like the story behind a particular asset they still consider it too risky. They would prefer to do a big multi-level shed in a green field let to an e-commerce operation yielding 4.5 percent than a viable retail property with a cash-on-cash yield of 8 percent. It feels as if when we speak to 20 investors about retail one is interested in continuing the conversation and 10 will just shut the door on us. In contrast, 15 of those investors will say straight away that they have a demand for logistics, despite it being the most competitive and expensive sector at the moment.

It is especially difficult to promote a retail opportunity to investors that do not have a real estate team, but even when they do, and those people accept the argument for making the investment, they still have to sell the idea to their own board. Some real estate teams tell us that while they may really like a particular asset they can just forget it because they only have to utter the word retail to their board and they are marched out of the door.

Retail property fundraising is immensely tough. We have extended the marketing period for our Europe V Retail Fund, but the €100 million we have been able to raise so

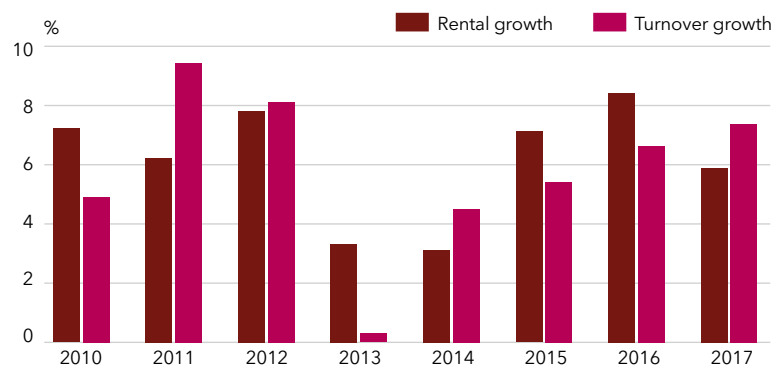
## Asset case study: Troyes Designer Outlet



**Purchased by Savills Investment Management in December 2019 together with a smaller outlet center in Roubaix, Troyes was the first purpose-built designer outlet in continental Europe and remains the largest such scheme in France**

Opened	1995
Vital statistics	More than 100 stores totaling 323,000 square feet of gross lettable area and 1,700 parking spaces
Vendors	Funds managed by US-headquartered asset management group Ares Management Corporation and specialist operator McArthurGlen
Purchasers	A club of French, German and Norwegian institutional investors managed by a Frankfurt-based multi-manager, and Savills Investment Management funds including the Europe V Retail Fund.
Debt finance providers	Société Générale and Deutsche Bank-owned asset manager DWS Group.
Operator	McArthurGlen will continue to operate the outlet and retains an ownership stake
Future development	Savills Investment Management plans to build a further 69,300 square feet of retail space by infilling the central parking area.

### Turnover and rental growth





far is fully invested. As a manager I would rather be in a market where there is less competition. In the retail sector we sometimes see more value on a risk-adjusted basis than we do in the logistics sector, but you have to be picky.

### Q So where can investors find value in the retail sector?

Retail formats that have a defined catchment and provide a draw for customers, and which are less sensitive to the cost issues and the spread of e-commerce, will have greater resilience. The obvious ones are value and convenience retail. At the value end of the market, e-commerce is unviable because it costs the retailer so much more to deliver low-value goods than sell them in a store. Budget fashion chain Primark is a classic example of a value retailer that does not have an e-commerce platform. And if a customer wants something here and now, they will not wait 24 hours for delivery, they will go to a nearby convenience store.

That advantage also applies to retail near transport nodes like railway stations, airports and ports – although infrastructure-related retail is very difficult to acquire – and to retail that accompanies public gatherings and events. No property is completely immune to the pressures generated by high costs and e-commerce, but if your tenants are selling low-value or convenience goods on a park where the trading economics make sense for them, they are far more likely to remain

*“It is easy for investment boards to treat retail as a pariah at the moment, and not touch it under any circumstances”*

**KIRAN PATEL**  
Savills Investment Management

viable. As a manager you have to get granular in your analysis.

Meanwhile, at the luxury end of the market retailers use formats like designer outlets to sell discounted products – you do not find a Gucci bag selling on the internet at a 30 or 40 percent discount, for example – so that asset type also offers greater resilience. As a house we are focusing on the resilient sectors within retail. For example, we have recently bought two designer outlet centers at Troyes and Roubaix in France. Formats

that require the customer to be physically present will be more robust in the face of e-commerce. The health and beauty business is currently worth \$550 billion and is forecast to reach \$750 billion by 2024, and more stores of that type opened in Western Europe in 2017 than any other retail outlet.

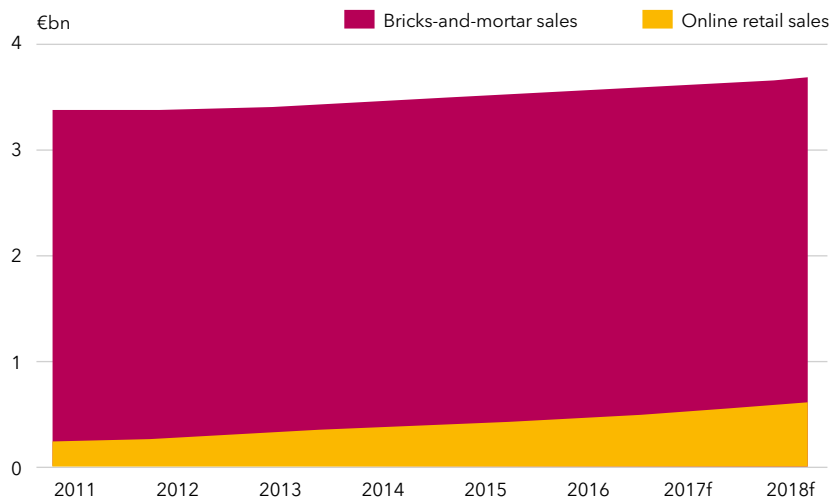
I believe retail parks are also capable of adaptation to the changing retail landscape, although that process is far from complete at this point. Having large blocks of retail gives you the ability to ‘cut-and-paste’ so you can reduce, expand or evolve particular retail offers according to demand. With most retail it is hard to knock down one part of it and keep another. In a retail park you also have the advantage of being able to put in click-and-collect facilities at the rear of the units.

### Q And which sub-asset types will suffer most?

High streets and shopping centers are harder to manage successfully in this environment. You cannot cut off one corner of a shopping center and do something else with it because you have too much space. High street retail can shrink and return to uses like office and residential, but to do that there needs to be demand for those uses. Certain high streets where you have a catchment draw will retain their vitality, while others are dying and they will need to find tenants that fit with a convenience approach and not a destination one. Some town centers are now attracting service-type operators like banks, charities, hairdressers, tattooists and nail parlors, as well as convenience, food and specialty shopping.

However, bricks-and-mortar retailers have faced constantly increasing costs for more than 20 years and at some point rents need to fall, which means certain properties in the retail sector are overvalued. Whether that puts shopping center owners in a really distressed situation depends on how far values decline. Will owners start to breach the loan-to-value levels on their debt covenants? We do not yet know how much debt is secured against this type of real estate, and where the thresholds are, so it is hard to get a grasp of that. Then you have to overlay that with sentiment. If liquidity in the asset class is drying up, what price makes it attractive for buyers? An asset might look like a bargain, but is it really? There may be opportunities to tear some centers down and redevelop them, but values have to drop sufficiently so you are not paying for the building, just the land and the change of use. ■

Physical stores still account for the vast majority of European retail sales, but online is growing



Source: Oxford Economics/Ecommerce Europe/Savills IM

# Mind the retail gap



Guest comment by **Henrike Waldburg**

*Europe's retail markets differ widely and investors must be aware of the growing chasm, says Union Investment's head of investment management retail*

European retail markets are mostly in good shape at the start of 2019. However, retail investors in Europe will need to adjust to a growing gap between robust retail markets and those subject to high risk in the long term.

Union Investment's Q4 2018 Global Retail Attractiveness Index (GRAI) shows there are 25 points between the current top performer, Portugal, and the weakest market in Europe, Belgium. This difference is the largest recorded for the index over the past 12 months. The ongoing positive economic climate in Europe, which is delivering rising revenues for online businesses as well as brick-and-mortar retailers in almost every country, is softening this trend at present. However, any sustained weakening of consumer sentiment is likely to cause retail markets to drift further apart.

The German retail market remains one of the top performers globally. Its stable top-tier position is due, in particular, to consistently strong increases in retail sales. Germany is also the only country in the GRAI's 2018 EU-12 index to see a slight rise in consumer confidence compared with Q4 2017 (+2 points). In all the other European regions surveyed, consumer confidence in the domestic economy is deteriorating to a greater or lesser extent. The buoyant employment market and optimistic income expectations mean German retail markets are particularly well supported. Local players, and increasingly also foreign investors, are attracted by the prospect of very predictable cashflows.

Alongside Germany on 115 points, the top tier includes the Eastern European

countries of Poland, with 118 points, and the Czech Republic, with 117 points. Like the Czech Republic, Portugal scored more highly than in 2017, gaining two points to reach 121. This puts it in pole position in the EU-12 index for the first time.

Portugal has successfully worked through its serious financial and economic crisis and regained its popularity among retail investors. Another southern European country has made it into the top five for the first time: Spain, with 114 points. This is due

Portugal is Europe's top performing retail market in Union Investment's Q4 2018 Global Retail Attractiveness Index

Country	Index score Q4 2018	Change from Q4 2017
Portugal	121	▲ +2
Poland	118	▼ -2
Czech Republic	117	▲ +2
Germany	115	▼ -2
Spain	114	◁▷ 0
Ireland	111	▼ -6
Italy	110	▼ -4
Netherlands	109	▼ -1
Austria	105	▼ -2
United Kingdom	104	▲ +6
France	100	▼ -11
Belgium	96	▼ -3
EU 12 average	110	▼ -2

Source: GfK, EU Commission, Eurostat (Index score reflects consumer and business retail confidence, and incorporates changes in inflation and retail sales performance)

to particularly strong sales in the Spanish retail sector, underlining the optimism being felt on the provider side. Ireland, previously a major concern, scored less well with 111 points, but despite a marked decline – minus 6 points – still performed better in Q4 2018 than mid-ranked countries such as Austria, Italy and the Netherlands.

## Sales rising

In line with the current three-way split in the European retail market, consumer sentiment, business sentiment and the consumer price indices vary significantly from country to country. But across Europe, rising sales in brick-and-mortar retail and by online businesses are largely a common theme. The indicator for retail sales performance gained a total of 15 points compared with the previous quarter. Accordingly, the EU-12 index lost very little ground overall compared with the last survey in Q4 2017 (minus 2 points).

From an international perspective, Canada, the US, Japan and Australia – in that order – are the retail markets we believe offer the best prospect of attractive returns in 2019. However, even here investors need to take a very selective approach as the retail landscape in some of these major markets is experiencing more serious upheaval than the European markets are likely to face. Germany will not necessarily follow the same trends, but the transformation process is forcing brick-and-mortar retailers everywhere to be more creative. New business models and concepts will emerge in brick-and-mortar retail, which may evolve into distinct asset classes. There is still some way to go in terms of differentiation. ■

# Will debt dry up for UK retail?

*Property values are falling, forcing lenders  
to question their exposure to the sector.*

*Alicia Villegas reports*

In June 2016, the UK's then home secretary Theresa May visited the Nicholsons Shopping Centre in her constituency of Maidenhead, a town 25 miles west of London. The mall had been bought the previous March by private equity-backed property firm Vixcroft and private credit manager Cheyne Capital with the promise of a revamp. The soon-to-be prime minister was checking in on the upgrade.

"We want to see more shops and businesses attracted to the town center so that it can become a vibrant hub for the community," May said on her visit. The opposite happened. As the UK's bricks-and-mortar retail crisis hit, several tenants vacated Nicholsons. Last October, it became the first major example of a UK shopping center to be placed into receivership during the current cycle – a consequence of its failure to meet its debt obligations. The scheme was bought for £37 million (\$47.6 million; €42.5 million) in 2015, backed by a £26 million loan from Hermes Investment Management, according to reports.

"Retail is challenging in the UK at the moment," says Morgan Garfield, managing director of Ellandi, a property company specializing in managing shopping centers across the UK and which took on management responsibilities for Nicholsons in 2017. "Across Europe, there is growing online penetration that will reshape the retail

landscape. In the UK, Brexit is an additional complexity. The effective devaluation of sterling since the referendum has increased retailer costs and eroded profit margins while uncertainty has undermined the confidence of occupiers and investors."

Consumer confidence continued to decline in the fourth quarter of 2018, according to data from Deloitte Consumer Tracker, as uncertainty surrounding Brexit reached new highs. Retail footfall registered a year-on-year decline of 2.1 percent in 2018, according to retail analysis firm Springboard.

The fate of Nicholsons – since acquired by Tikehau Capital and Areli Real Estate – highlights the tough decisions facing real estate lenders as the high street and shopping center retail crisis intensifies. As capital values plummet, debt providers are forced to consider the health of their loans to retail properties, as well as their long-term exposure to the sector.

## **Falls in value**

The challenge for lenders is ascertaining how much the collateral to their retail loans is worth. Data provider MSCI recorded a 5.7 percent decline in capital growth across the UK retail sector during 2018. CBRE's monthly index, meanwhile, showed an average drop of 10.5 percent for shopping centers over the same period. Fund manager Fidelity International's prediction is a drop

of 20-40 percent for prime retail, with secondary stock expected to fall in value by as much as 70 percent.

"There is a debate as to whether valuers are reacting quickly enough to the reality," says Nick Knight, executive director and valuation specialist at CBRE. "I can understand how people looking at average values in published indices might say it feels worse out there than the numbers show. But I'm disappointed by suggestions that it is valuers' conflicts of interest that is keeping values high. You only need to look back to the global financial crisis, when values were written down by 40 percent, to see this is not a community that is afraid of taking values down."

The lack of transactions in the sector means valuers have limited comparable data to draw on. Savills data show 2018 was the worst year for UK shopping center investment volumes since 1997, with a total turnover of £1.3 billion across 34 deals, down 60 percent on the long-term average.

"Valuing retail now involves balancing sentiment and evidence," says Savills' head of valuation, Ian Malden. "Investors are placing less emphasis on yield; it is more about the true cashflow and geared returns. Falling rental values and questions over the sustainable income going forward are very relevant. Valuers also need to increasingly consider the value in a repurposing scenario, which adds a new dynamic to the valuation matrix."



In receivership:  
Nicholson's  
Shopping Center,  
Maidenhead,  
England

Knight expects more pain: "There is further to go. History tells us that when you reach an inflection point in the market, there can be a time lag."

Lenders must also decide whether to take enforcement action if loan-to-value covenants are tripped in their facilities. Anecdotal evidence suggests lenders are desperate to avoid situations of default. The financial crisis of 2008 remains fresh in lenders' minds and many are understood to be reluctant to take measures that would mean admitting property lending has, again, resulted in failures.

"Some lenders have put pressure on borrowers to cure LTV breaches," says one UK debt advisory specialist, "but lenders are nervous of defaults, because they remember the pain they went through in the crisis."

While lenders we spoke with did not refer to specific situations they, or their peers in the industry, might be involved in, they argued that most debt providers will be taking a considered view of the properties they are financing, rather than panicking at the fall in values.

### Income eroded

The slew of high-profile retailer administrations in the last six months has created a real danger to retail income. Retail property experts also point to the damaging impact of retailers using company voluntary arrangements – deals allowing them to reduce

*"Banks are pulling back from retail and there is a definite focus on the best examples of retail, which means outlet centers and retail warehouses are an easier sell than high street units or shopping centers"*

**JAMES WRIGHT**  
Link Asset Services

rents as part of a survival plan – which many consider an abused tool in recent months. The traditional upward-only rent review, it seems, is not sacrosanct.

"Tenant failures and falling rents will erode net operating income," says Garfield. "If, in turn, this has an impact on the ability to service debt, lenders will have to act."

Sector analysts do not expect pressure on retailers to let up. The Centre for Retail Research expects 22,100 retail closures this year in the UK, up from 18,443 during 2018. Andrew MacDonald, head of real estate finance at asset manager Schroders, is one of those who see the threat to income as the most immediate concern for lenders.

"In the financial crisis, it was more a capital value-led issue," he says. "Lots of loans breached LTV covenants because of yields rising, but income was still robust in lots of those loans. The issue this time for retail is on the income side of the equation. Loans breaching their income coverage ratio covenants is more of an issue than LTV breaches."

Some, including Trevor Homes, head of senior lending at debt fund manager DRC Capital, are convinced income will hold up across many UK shopping centers, despite the crisis. "Income is holding up at a lot of shopping centers, so although there have been a few administrations, we are not seeing ultra-low occupancy at shopping centers. The serviceability of debt is usually



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sustainable. The lending was generally done on sensible terms in the first place.”

While lenders are not, at this stage, pulling the plug on their existing borrowers en-masse, sourcing new finance in the retail sector is understood to be difficult. Banks are negative on the asset class in general, despite protestations from some in the industry that parts of the sector, including leases to the major supermarket chains, remain robust.

The long-term liquidity of retail property debt is in the balance, and may cause problems for those sponsors in need of refinancing come the maturity of their current loans. Many of these fall due at the end of this decade, with Savills identifying 2020 as the market's refinancing spike. Given many assets across the UK are owned by private equity funds that have deadlines to return capital to investors, debt for refinancing is a necessity.

Lenders have also taken a more conservative approach to underwriting during this cycle. Leverage levels typically fall below 60 percent, compared with the 85 percent-plus seen before the crisis.

Debt advisory specialist James Wright, head of the real estate finance business at Link Asset Services, recalls the challenges of sourcing debt for clients in recent situations. “Banks are pulling back from retail and there is a definite focus on the best examples of retail, which means outlet centers and retail warehouses are an easier sell than high street units or shopping centers. It comes down to the covenant strength, lease lengths, the quality of the real estate, but also increasingly the alternative use value.”

Although banks do not tend to signal cooling appetite for a sector, there is an acknowledgement from many that retail is problematic. Where banks retrench, alternative lenders tend to in-fill and sources say the market is playing into the hands of those debt funds with higher risk/return profiles.

### Filling in the gap

Some alternative lenders see the fall in retail values as an overcorrection and will lend, if vacant possession value is higher than the loan volume. Others argue alternative sources of capital will not be the cure-all for those in need of retail finance, with some institutional investors, which back many alternative lenders, sharing banks' qualms about the retail sector.

*“People’s shopping patterns are changing. The internet is not the reason some retailers are suffering – it is because they have a tired offering of the wrong products. The internet just exacerbated the situation”*

**TREVOR HOMES**  
DRC Capital

The factors causing the retail crisis are not going away. A bifurcation in whether retail properties can attract finance is likely to emerge, with properties that have been re-vamped or repositioned attracting finance, and those which simply do not work in the modern retail environment losing lender support. A major consideration for lenders is what the next generation of UK retail property owners looks like. While better performing assets will remain largely in the hands of institutional ownership, or in the portfolios of listed property companies, there is much debate around who will step in to buy bargain assets that hit the market in the near term.

The vultures are already circling distressed situations. “Many private equity investors, ranging from real estate private equity funds to hedge funds, are eyeing the retail sector, some of whom are looking at the debt as a way in,” says Christopher Daniel, founding partner at Quadrant Estates, which owns retail property across the UK.

However, many believe the work-out of

the UK's distressed retail will require investment and long-term thinking, rather than short-term profit.

Buyers are likely to tackle problem retail in joint ventures in order to bring a combination of capital and expertise to the table, says DRC's Homes: “It might include local authorities, which have the incentive to make these schemes work. When product came out of NAMA [Ireland's National Asset Management Agency], buyers knew they could do a quick turnaround. Those easy wins are not there at shopping centers – if they were, the existing sponsor would be doing it.”

### Shopping for bargains

There is evidence of institutional investors taking the opportunity to buy into the sector. For example, LaSalle Investment Management is reported to be close to buying The Galleries mall in Bristol from Infrared Capital Partners.

“We will definitely take advantage of current pricing, to be very selective on stock,” says Mahdi Mokrane, LaSalle's head of research and strategy, speaking generally about the possibility of buying assets in a changing retail landscape. “Key considerations for us are location and asset flexibility – dominant urban shopping centers are typically more attractive to us – and capital expenditure, as retail assets need more capex to convert spaces to increase footfall or for alternative uses.”

Just as investors see positive fundamentals in segments of the retail sector, lender appetite will be determined by the individual fundamentals of an asset. “Retail is not dead, but we need to recognize in the UK that we have too many shops,” says Homes. “People's shopping patterns are changing. The internet is not the reason some retailers are suffering – it is because they have a tired offering of the wrong products. The internet just exacerbated the situation.”

The full extent of the UK's retail crisis is not yet apparent. What is clear, however, is that lenders are reacting. At this stage, the receivership at Maidenhead's Nicholsons is not the norm, but as loans come due at struggling shopping assets, more lenders are likely to pull the plug. Further forward, lenders will assess their appetite for the sector; retail, many point out, is not dead, but the wrong kind of retail – the dated stock that does not fit with the times – will not be worth lenders taking the risk. ■

# KEYNOTE INTERVIEW

## Happy shoppers



*The outlook for Australia's retail market, even brick-and-mortar, is positive, argues **Matthew Strotton**, QIC's director of capital, global real estate*

Retail property in developed markets is struggling across most of the world; as the retail business digests the impact of e-commerce, stores have closed and investors have shunned the sector.

Australia has not been immune to these problems, with rents flat at best for the past two years and muted transaction volumes. The launch of Amazon Australia last year did not cause the expected meltdown, but some retail analysts expect it to dominate the market within seven years.

However, QIC, one of Australia's largest retail landlords is upbeat about the future of brick and mortar retail, believing there is plenty of room for growth in both online and offline sales. Based in Brisbane, QIC owns 22 major Australian shopping centers across the country. *PERE's* Mark Cooper talks to Matthew Strotton, global director, capital, at QIC Global Real Estate about his reasons to be cheerful about the prospects for the group's retail portfolio.

### SPONSOR QIC

#### **Q We hear a lot of pessimism around retail investing right now; is this justified?**

In my 20-year career, I have never felt the level of scrutiny we are getting in the retail sector today. I am not sure I would categorize it as pessimism, but there is a range of unknowns around retail which have yet to be fully answered. Our retailers have been disrupted; they have had to virtually reinvent the way they invest in their business. And retailers have had to contemplate a new future for their business in both physical stores and online, trying to strike an effective balance between the two to maximize sales, and to maximize recognition of their brand.

The pessimism is focused on capital markets. Capital markets are driven by investor demand and the supply of good stock.

At the moment, what we are seeing is a reticence, at almost at all levels, from investors regarding the retail space because they are concerned about the unknowns regarding the position of retail.

However, our retailers are going through this tech-led evolution, but they are now emerging, and what has happened along the way tends to grab the negative press with respect to bankruptcy, store closures and store rationalizations. But what that means, in its simplest form, is that retailers are reinventing themselves and adapting to the new market.

#### **Q Looking specifically at retail real estate in Australia, is there more cause for optimism?**

Over the past 12-28 months, there has been a combination of factors which have placed a great deal of uncertainty over households in Australia. House prices ran up a long way and have faltered. The banking enquiry

meant less lending from the big banks and that put pressure on household finances. And finally, the federal election created uncertainty. All of those factors, from my perspective, have been a significant contributor to lower confidence.

Today, we see all those factors mitigated by the liberal party's election win, which delivers political certainty, and the prospect of additional interest rate cuts coupled with an adjustment of the rules associated with home loan serviceability, which should see falls in house prices bottom out and allow for improved household refinancing, and support retail sales. So there is going to be a vastly different picture looking forward and a vastly different proposition for retail in this country.

**Q Talk us through the positive fundamentals you are seeing right now in the Australian market, which make retail real estate an attractive investment proposition?**

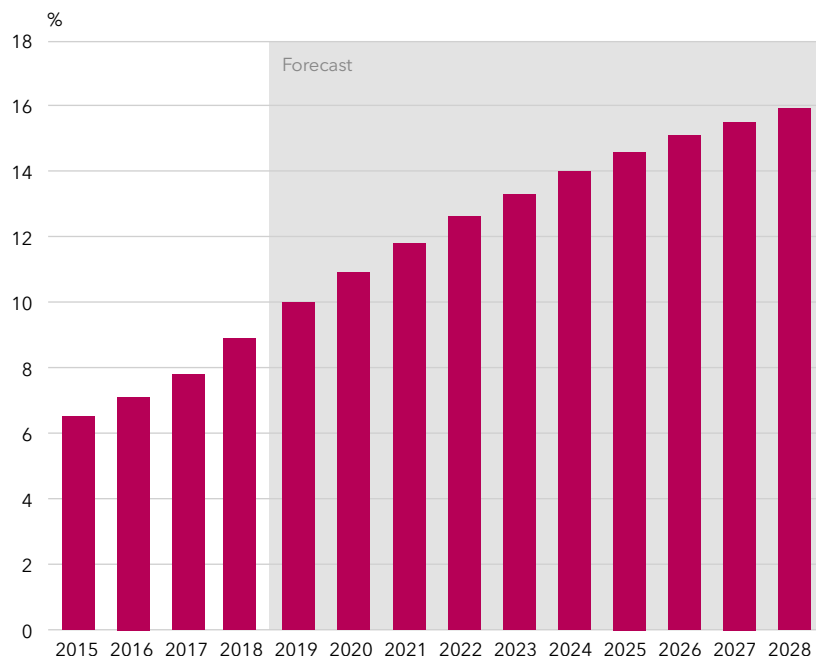
The outlook for the Australian economy remains robust and among the strongest of the major advanced economies and Australian consumers are generally in good financial shape. Over the next decade, we forecast Australian real GDP growth to average a solid 2.6 percent per annum, in line with the trend in growth seen over the past decade. We have had nearly 30 years without a recession, unemployment is low and we have a public infrastructure boom, which will drive growth.

It is also important to remember that even though we have been at the bottom of an economic cycle, we are still, as a business, recording positive net operating income growth, as are our peers in Australia. We are still achieving momentum in leasing. All of these operating fundamentals remain in place, but were somewhat anaemic, which is representative of a trough in the economic cycle.

**Q QIC's recent report on the Australian retail sector says that online sales are expected to grow from just under 9 percent to almost 16 percent in the next decade. What impact will this have on brick-and-mortar retail?**

It is important to put that figure in context. What it tells us is that 74 percent of sales will come from physical retail platforms. Moreover, we do not see this online growth necessarily coming at the expense of brick-and-

E-commerce sales are expected to continue rising in Australia over the next decade reaching almost 16% in 2028 before stabilizing, meaning most sales will still come from physical retail



Sources: ABS, NAB, QIC

-mortar retail. It is not as if retail businesses are either purely online or purely physical or that they are competing for a finite market. A substantial amount of online sales are linked to a retailer's physical presence and a lot of growth in the future is going to be through omni-channel retailing rather than purely online sales.

Our retailers, certainly the most successful of them which are ahead of the curve, are reaching a point now where they have firmly cemented their future. Like us, our retailers are focused on providing an experience that cannot be replicated on digital platforms but work in synergy with them. They have worked out how their business is going to be built: around the success of a physical location, augmented by an online presence, both of which enhance their brand and amplify the interest of consumers to come and buy.

Over the next decade, we expect brick-and-mortar retail sales to expand by an average 3.2 percent per annum. This is only about 80 basis points below the 4 percent growth expected for overall retail sales during this period.

**Q In this new retail landscape, how should investors in the sector adjust their strategies and portfolios?**

I would have them come back to the drawing board on retail. Come back to quality and locality, come back to value enhancement through cycles. Come back into positioning for growth. Come back into diversified income streams. Fashion was at one point effectively 100 percent of rental income and that is down to 60 percent today. There has been significant growth in food and beverage stores and that will continue, as will growth of health and wellness facilities. Active management of the tenant mix will not only boost a shopping center's resilience to e-commerce, but it will also target areas with stronger growth prospects due to shifting consumption patterns.

Our business after all is not retail. Our business, from our perspective, is investing in communities and generating a diversified income stream that we continue to grow cycle after cycle. I firmly believe the retail sector, particularly regional shopping centers, has just experienced its first super cycle from the inception of the shopping center concept to maturity. The institutional real estate market in Australia is only 40 years or so old and the major shopping centers are younger than that, so not even middle aged yet.

So investors need to be looking at the next 25 years and how those centers and





Experience retail:  
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Queensland

those locations will develop. In Australia, the planning system protects those locations and the ownership by entities like QIC, which can take a long-term view and invest capital for the long-term, which means they can be developed as community centers. In the future, they will be more densely developed and with a greater mix of uses.

Inevitably, we will augment the expertise that we have in-house, which is retail and entertainment-focused, and focused on enlivening communities, and enhance our resources around office and residential, sub-sectors such as short-term accommodation, education and medical. Nonetheless, the way in which we deal with this next super cycle needs to be more patient, more cautious. The fundamentals of budget management, of capex management are as important as ever and there are still unknowns, and you do not throw cash at unknowns.

Retail is going to become more management intensive over time and it is going to be increasingly important for investors and managers to be close to their retailers and understand what is driving them. We spend a lot of time on this and that is what is needed to be able to generate leasing tension, which drives rental growth. I also think it is inevitable that our market will become closer and closer to Asia. That is most definitely our future, and there are things we can learn from our northern neighbors and apply to our hometowns in terms of vertical retail and retail-led mixed use.

*“A substantial amount of online sales are linked to a retailer’s physical presence and a lot of growth in the future is going to be through omni-channel retailing rather than purely online sales”*

**MATTHEW STROTTON**  
**QIC**

**Q Is the retail investment opportunity uniform across Australia? Are you seeing pockets of opportunity in particular locations?**

In one sense, the opportunity in Australia is uniform and more so than in other countries. This relates to the planning regime in our country. Everything from the manner in which we operate leases, charge insurance, manage insurance, the issuing of title, is uniform across our country.

For real estate generally over the past few years, there has been quite a variance of performance between Sydney and Melbourne, and Perth and Brisbane. However, there are signs that the resources sector is on the up again, which is good for Perth and Brisbane. Growth in the resources sector means more migration into Queensland and Western Australia and that is good for retail. We like Perth as a long-term market and have a retail asset there but the market has been subject to greater cyclical variations. We are actively considering new acquisitions in that market.

However, our investment decisions are based on bottom up fundamentals. The idea of comparing Perth and Melbourne, Sydney and Brisbane, is different for offices, compared with retail. For retail it is vastly longer-term, and if anything is more granular for our investment decisions. Will an asset or an area enable us to generate outperformance because it is growing more strongly than the city or the country as a whole? We are not aiming to ride the cycle and sell out at the top, but to manage assets through cycles. ■

# Retailers' new mantra is transform and evolve



Expert comment by **Mez Birdie**

*National Retail Tenants Association member and NAI Global's director of retail and investment services offers a tenant perspective of the US sector*

While 2019 will experience more store closings than in 2018, a generally dynamic retail sector together with shoppers' ongoing demand for physical store locations – despite tales otherwise – new concepts and a healthy economy will continue the positive US retail environment we are currently seeing.

Successful retailers are embracing the lessons learned from the last few years, realizing it is not just the location of stores that matters, but that they must transform their business models quickly and evolve their brand to remain relevant to consumers and to continue their story well into the future.

The idea that there is a 'retail apocalypse' is a myth. In fact, total retail growth was a healthy 3.1 percent in 2018, according to the *US Retail Sales Report, Current Statistics and Recent Trends*. Simply, the sector has been in the midst of transformation over the past couple of years. And this transformation is progressing well. New retail concepts are successfully replacing the traditional due to changing shopping habits. For example, Amazon Go and Amazon Marketplace are disrupting the retail convenience store sector.

## **New-style tenants drive demand**

Medical and dental clinics, health clubs and wellness centers, and municipalities are examples of the types of growing businesses now occupying the empty retail space left from the closure of more traditional retail businesses. Real estate developers and owners are welcoming this transition as these smaller to mid-size non-traditional retailers

are often willing to pay double the rent of more traditional anchor tenants and big box stores.

And these new tenants also want real estate developers and owners to add residential, hospitality and distribution components to retail developments because these segments bring added customer traffic. They want retail centers and malls to provide 'entertainment' components to enhance the customer experience, encouraging shoppers to stay longer and spend more time at malls. New restaurant concepts along with entertainment venues such as food halls, wine and piano bars are accommodating this need.

Both online and physical retailers recognize they must integrate the business models of both channels to maintain relevance,

as demanded by the customer. Convenience will continue to accelerate as a top consumer value and consumers will continue to push for more evolutionary shopping experiences.

To continue to be successful in this evolutionary time, retailers are having to adjust to the effects of the business disruptions in our industry – retail bankruptcies, store closures, tax law changes, mixed-use development, natural disasters, downsizing/rightsizing and Financial Accounting Standards Board accounting changes, to name just a few. It is the retailers' responsibility to manage these disruptions proactively, by ensuring they are located in vibrant and well co-tenanted shopping centers, diligently enforcing their tenant lease rights and the obligations of our landlords, and effectively managing occupancy costs to protect the profitability needed to transform and evolve.

Considering the fast pace of change, the real estate management and lease administration segments of our sector must leverage technology to do some of the heaviest data lifting for retailers, providing transparency of our lease and portfolio information to other business partners to improve speed and effective business decisions.

Protecting profitability during times of change and uncertainty is difficult. It is the retail sector's responsibility to build the organizational flexibility needed to meet their evolutionary needs by focusing on training and developing talent, so that their lease administration teams become key contributors and differentiators of lease language and terms. ■

*“Smaller to mid-size non-traditional retailers are often willing to pay double the rent of more traditional anchor tenants and big box stores”*

# Asia moves ahead of the curve

*Strong economic growth, the embracing of omni-channel retailing and the status of the shopping mall are among the reasons for the region's retail resilience, writes **Mark Cooper***

Retail landlords have had a torrid time in recent years, as they try to cope with the impact of e-commerce on tenants and their assets. The growth of online retail is a global phenomenon, yet landlords in Asia seem to be suffering less than those elsewhere.

The UK and US appear to be suffering most; in the US, shopping centers are losing department store anchor tenants at an alarming rate, while the UK high street has been hit by a wave of retailer failures.

Chris Heady, chairman of Asia-Pacific and head of real estate Asia at Blackstone, says: "Retail all over the world has been facing some headwinds due to the emergence of e-commerce; online retailing is akin to adding more physical supply to the market."

However, retail in Asia appears more resilient. CBRE reports shopping center vacancy in China fell to 6.5 percent from 9.5 percent between 2013 and 2018, while JLL's Asia-Pacific shopping center rental index shows steady growth since the GFC.

Overall, however, investors have tended to lump in retail in Asia with other regions: retail investment in the region dropped from \$29.5 billion in 2017 to \$19.7 billion last year, according to CBRE data. CBRE's 2019 investment intentions report for Asia-Pacific, Europe and North America show retail is behind office, residential and logistics when it comes to investor preferences.

Some global private equity groups have been bucking the trend and investing heavily in Asian retail assets. Blackstone owns stakes in nine shopping centers in India through its Nexus Malls platform. The group also

acquired 50 percent of US retail property specialist Taubman's stake in a portfolio of three newly built and fully occupied shopping centers in Asia – two in China and one in South Korea – for \$480 million. Blackstone has also bought an office complex and VivoCity shopping mall in Shanghai, reportedly for \$1.2 billion and was part of an investor consortium to acquire a 12-shopping center portfolio from Hong Kong's Link REIT for HK\$12 billion (\$1.5 billion; €1.4 billion).

Warburg Pincus has invested heavily in Asian developing market retail. In May, India's Runwal Group announced it had formed a \$1 billion joint venture with Warburg Pincus to develop shopping centers across the nation and earlier this year, Warburg Pincus-backed platform NWP Retail raised \$200 million to boost its Indonesian development program. Warburg Pincus has also been investing in Vietnamese retail assets since 2013.

Asia-based private equity groups, including ARA Investment Management, Arch Capital and SC Capital have also acquired retail properties in the past 12 months.

"There are a couple of factors which have benefited retail in emerging Asian markets," says Heady. "The first is that the retail industry is earlier in its evolution so there is less retail real estate per head than in more developed markets, which leads to less competition."

## Promising fundamentals

Data from Cowen and Company, ICSC and Cushman & Wakefield show the US has 23.5 square feet of retail space per person, while the UK has 4.6 square feet and Japan 4.4 square feet. However, China has only 2.8



square feet per person, Thailand 2.3 and Indonesia only one. This relative undersupply means there is far more potential for growth in less mature Asian markets.

"Secondly," says Heady, "many Asian countries have a growing middle class, which has been the beneficiary of rising wages and increasing availability of finance, and this has translated into growing retail sales."

In April this year, China's retail sales growth fell to its lowest level in 16 years. However, that level was 7.2 percent annualized, while the best the US has managed in the past decade was 5 percent in 2011. It managed 3.1 percent annualized this April. Asia's developing economies are seeing even more dramatic growth: the most recent figures for Indonesia show 10.1 percent annualized retail sales growth in March and for Vietnam 11.1 percent in the year to May.

Liz Hung, associate director, Asia-Pacific research at CBRE, argues that Asian retail landlords have been quicker to adapt to the new retail environment. "Landlords in Asia have been very quick to catch up on trends. For example, the change toward including more F&B space has moved very quickly in





Starfield Hanam mall: Blackstone acquired a stake in one of China's biggest retail centers

this region. Landlords have also been willing to include more entertainment and leisure facilities, aside from the usual cinemas.”

The key trend, of course, is e-commerce. Chris Wu, group chief financial officer at Chongbang Group, a Chinese developer of retail-led mixed use schemes, which is backed by APG Asset Management and Ivanhoe Cambridge, argues that China and its property sector have not just adapted, but embraced the new world of retailing.

“China is way ahead of the rest of the world in omni-channel retailing,” he says. “There are many examples of this, such as fresh produce vending machines and unmanned stores which use facial recognition. In addition, China is also very ahead in terms of online shopping – 18.4 percent of total retail sales are made online in China – and mobile payments, which underpins the environment and ecology that is necessary for omni-channel retail.”

Initially Chongbang focused on helping online retailers to go offline, says Wu. Alibaba's first online/offline He Ma Fresh Mart was opened at Chongbang's Life Hub@Jinqiao in Pudong, Shanghai. “However, in the last few

*“In the most successful malls, there is a strong connection between the center and the community”*

**LIZ HUNG**  
**CBRE**

years our focus has been helping a range of offline retailers, including food and beverage, entertainment and service outlet operators, to go online.”

Far from being a threat, e-commerce is a boon to Chongbang. “The integration of online and offline operations, and ultimately omni-channel retailing has expanded the market base for us, helping to solve one of the biggest problems of the retail industry in China – the shortage of retailers and brands, especially home-grown brands. Life Hubs now host brands that have not previously had a presence in malls,” says Wu.

### Community-centric retail

Another key advantage for Asia's most successful shopping centers is they are more embedded in the community. Most modern malls are built above public transport nodes and are part of a mixed-use development including residential, office and hotels. This means the malls are constantly in use and the development creates its own footfall.

“Successful mixed-use projects are very synergistic as people want to live, work and play there because of the amenities, usually retail-led,” says Wu. “In our experience, when you add in other elements, such as hotels, offices and residential, each of the elements performs much better than the average.”

Hung adds that Asian malls are more likely to be at the center of their communities, “the shopping centre as a social center, as a place where people want to spend their leisure time, is an important concept here,” she says. “In the most successful malls, there is a strong connection between the center and the community.”

While retail has a better story in many Asian markets, the region is far more heterogeneous than North America or Europe. For example, Hong Kong retail shop rents halved between 2013 and 2017, and have been flat since then. Many cities and submarkets in China and India are lumbered with excess supply of mall space.

There are also differences between Asia and the more developed neighboring markets of Australia and New Zealand. Australia is unusual in that it has 11.2 square feet of retail space per capita, more than two-and-a-half times the space per person of Japan, the most developed market in Asia.

Heady cautions: “There are still wide variations between markets in the region; investors need to be very selective about acquisitions.” ■



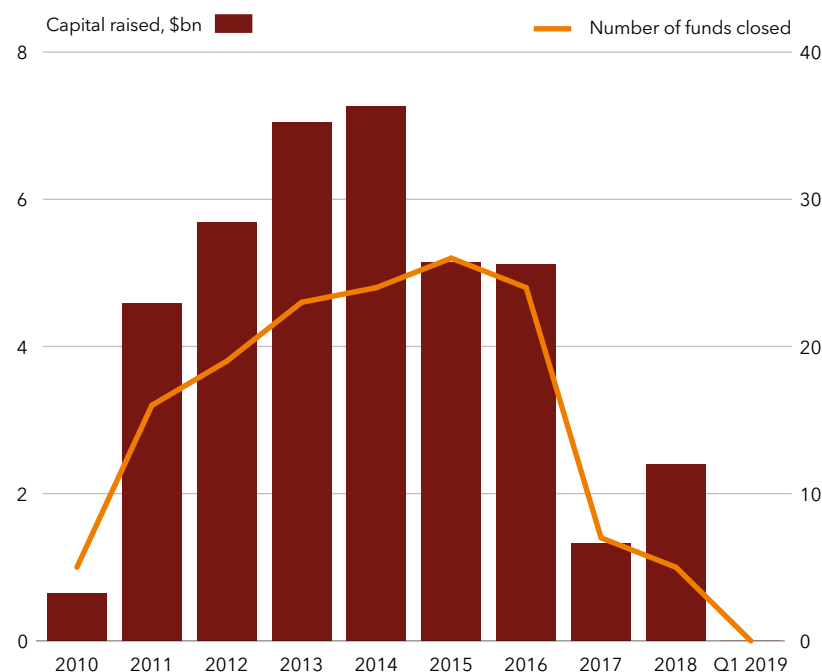
## A new low After a disappointing 2017, retail-focused fundraising bounced back in 2018, but Q1 2019 failed to register a single fund close. Will activity pick up in H2?

Six of the top 10 retail-focused funds in market are looking to raise capital in Europe

Fund name	Fund manager	Target size (\$m)	Fund strategy	Regional focus
Thor Urban Property Fund III	Thor Equities	1,000	Value-add	North America
Vanbarton Fund 1	Vanbarton Group	1,000	Core	North America
Asana Partners Fund II	Asana Partners	800	Value-add	North America
ERES APAC II-China Outlets	Nuveen Real Estate	750	Core-plus	Asia-Pacific
Europe V - Retail Fund	Savills Investment Management	573	Value-add	Western Europe, Central & Eastern Europe
Nordic Fund III - Retail Fund	Savills Investment Management	573	Core-plus	Western Europe
The German Retail Fund 2 - High Street Plus	Savills Investment Management	573	Core	Western Europe
Corpus Sireo RetailCenter Fonds	Corpus Sireo	515	Core	Western Europe
ORES Socimi	Sonae Sierra	458	Opportunistic	Western Europe, Central & Eastern Europe
GAM Real Estate Finance Fund II	GAM Holdings	447	Debt	Western Europe

Source: PERE. Figures as of March 31, 2019

No retail-focused funds closed in the first quarter of 2019



Source: PERE

# 35

Total number of retail-focused funds in market as of March 31, 2019

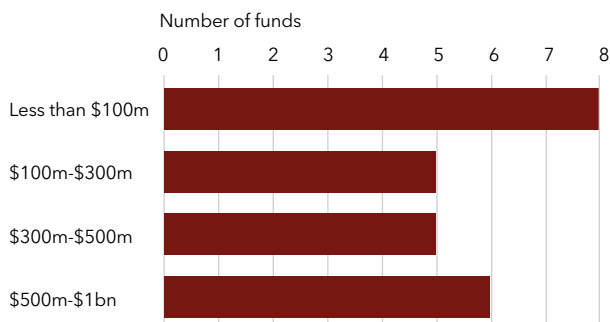
# \$9.5bn

Total capital targeted by retail funds in market as of March 31, 2019

# 0

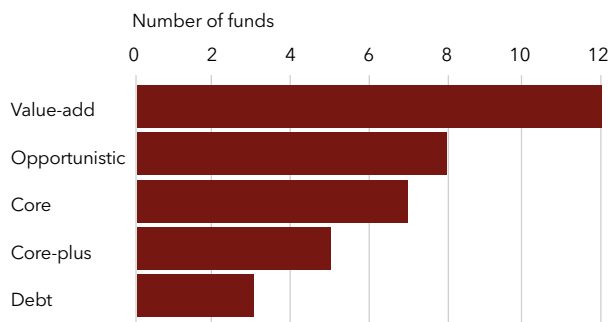
Number of retail-focused funds closed in Q1 2019

Retail funds in market are not chasing big ticket capital raises - only six are targeting in excess of \$500m



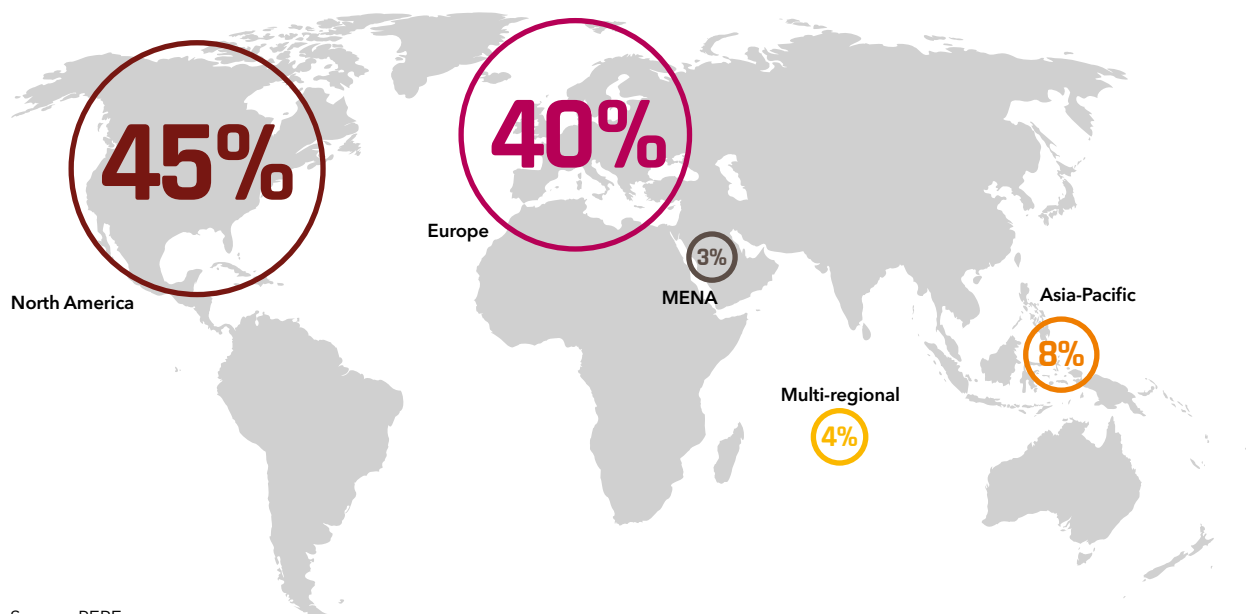
Target size information not available for all retail funds in market  
Source: PERE

Value-add and opportunistic are the strategies of choice for many retail funds in market



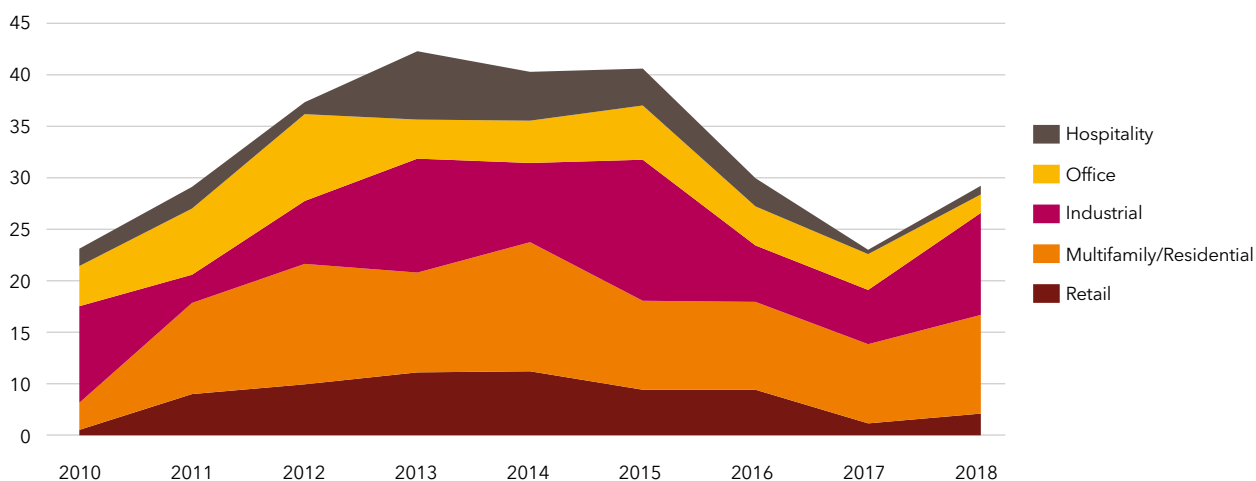
Target size information not available for all retail funds in market  
Source: PERE

Among retail funds in market, 85% are targeting North American and European capital in 2019



Source: PERE

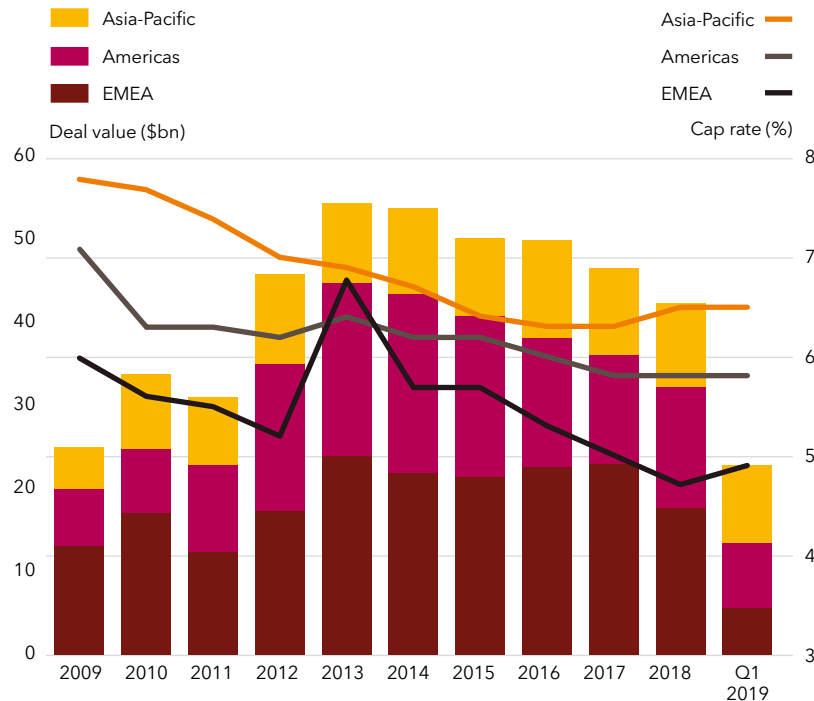
Fundraising for retail lagged well behind logistics and residential in 2018, showing institutional capital's cautious approach to the sector (\$bn)



Source: PERE

## Deal data Global retail transaction volume continued its steady decline in 2018, RCA data show

Asia-Pacific is the standout story so far in 2019, with retail property deal volume in the region higher than in EMEA and the Americas



Source: Real Capital Analytics

The 10 biggest buyers of retail property in the 12 months to Q1 2019 include some of the private real estate sector's top names

Company name	Location	Capital type	Volume (\$bn)	Property acquisitions	Average price (\$)
Brookfield Asset Management	Canada	Equity fund	18.10	180	100,366,594
Unibail-Rodamco-Westfield	France	Public REIT	9.50	42	226,555,069
Signa Group	Austria	Equity fund	2.76	130	42,576,022
Blackstone	US	Equity fund	2.17	36	60,335,762
Goldman Sachs	US	Equity fund	1.81	20	90,614,313
Bayerische Versorgungskammer	Germany	Pension fund	1.76	8	219,724,191
Gaw Capital	Hong Kong	Equity fund	1.53	13	118,065,980
Link REIT	Hong Kong	Public REIT	1.36	2	679,443,230
ByteDance	China	Corporate	1.34	1	1,342,460,203
China Resources Land	Hong Kong	Real Estate Operating Company	1.15	1	1,154,114,165

Source: Real Capital Analytics

# \$42.4bn

Total global retail deal volume in 2018

# \$9.4bn

Q1 2019 Asia-Pacific retail deal volume

# 180

Number of retail properties acquired by Brookfield Asset Management in the 12 months to March 31, 2019

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Artist impression - Castle Towers, Australia

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