KEYNOTE INTERVIEW

Opportunistic capital spearheads investors' return

Liquidity is returning to a restructured and repriced European retail sector, once again offering attractive risk-return characteristics, says Arrow Global's Zachary Vaughan

In recent years, the upheavals in retail real estate have placed many European shopping centers under the effective control of banks. For deep value investors, this presents an opportunity to acquire centers that have demonstrated resilience against e-commerce, and at highly attractive prices, argues Zachary Vaughan, global head and chief investment officer of real estate at pan-European investment manager Arrow Global.

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Q Are you seeing signs of recovery or restructuring within European retail markets?
For years, few managers were willing to propose a retail deal to their investment committees. However, liquidity is now beginning to return to retail real estate. Financing for acquisitions is becoming available, and as interest rates continue to fall, more capital is expected to follow.

Retail has been underinvested institutionally for quite some time, creating room for greater exposure in investment portfolios. Opportunistic investors are already beginning to re-engage with the sector.

The next phase will likely see the return of longer-term capital. For these investors, the retail sector offers the potential to acquire assets with stable, growing cashflows – delivering a meaningful premium over investment-grade bonds and generating attractive cash distributions.

Q With significant debt maturities on the horizon, how are European retail investors balancing refinancing challenges with opportunities?
The real estate sector faces a pressing need for substantial deleveraging. In many cases, upcoming debt maturities will trigger liquidity events, requiring owners to either inject additional equity, sell assets, extend loans or face lender foreclosures.

Across Europe, many retail assets are held by lenders. With limited

Case study: Arrow's acquisition of Allee-Center Leipzig

Arrow recently acquired Allee-Center Leipzig, a 40,300-square-meter (434,000-square-foot), daily-needs anchored shopping center in Grünau, one of Germany's largest residential estates.

Previously owned by a regional bank, the asset benefits from strong public transport links and a core catchment of 220,000 people.

Anchored by leading retailers such as REWE, Aldi and Saturn, Allee-Center boasts a high occupancy rate and a proven operating history, with robust footfall of 4.9 million in 2022. Leipzig, Germany's fastest-growing city, has seen its economy double since 2000 and is projected to expand by another 75 percent by 2035. The city is a hub for the automotive, biotech and logistics sectors, attracting a young and growing population, with 25 percent of residents aged 18-35.

The asset will be managed by Arrow Germany's real estate team, with a strategy focused on leasing opportunities and value creation. With strong fundamentals, strategic location and an underinvested past, Allee-Center represents a compelling investment aligned with Arrow's deep-value retail strategy.

SOURCE: ARROW GLOBAL

demand for these properties, lenders have been retaining them – either by working with existing borrowers or taking direct ownership. In some instances, the debt balance far exceeds the asset's value. However, as liquidity returns to the retail sector, these owners now have an opportunity to trade their assets.

Q What regions or types of retail assets are proving the most attractive at the moment?

The retail sector is at the early stages of capital returning. Smaller centers across Europe, particularly those located within or near major cities, are where we focus. Typically, over a third of the tenants – including some anchor stores – are daily-needs retailers such as grocery stores, pharmacies and fitness centers. These assets have demonstrated strong performance, and with no new developments of this type in the pipeline, their value is further reinforced.

Additionally, rents have been reset in recent years to levels that are now sustainable relative to tenants' sales turnover. In many of these centers, rents are starting to rise again. Some studies even suggest that retail rents in Europe could outpace logistics rents over the next five to seven years. At present, these centers can be acquired at highly attractive yields, making them a compelling opportunity for deep-value, opportunistic investors like us.

Q What are the chief considerations when selecting this type of asset?

Buyers must be highly selective, with a sharp focus on tenant mix and the spending power within the center's trading area. Most of the opportunities we target are in continental Europe. In the UK, shopping centers tend to be larger and require more operating capital, making the risk-adjusted returns less attractive.

We generally favor centers located in growing, middle-class, middle-income areas, primarily tenanted daily needs and mid-market retailers. These assets often fall within the €50 million range – too small to attract large institutions and REITs, yet slightly too large for some local buyers.

These properties are typically small-scale enclosed centers that function as extensions of the high street. From an operational perspective, this adds to their appeal, as local municipal authorities have a strong interest in supporting and sustaining these retail hubs.

Acquiring these assets at high single-digit yields is feasible, but careful consideration must be given to ongoing operational and maintenance costs. It is no longer realistic to assume that these costs can always be passed on to

tenants through higher rents.

Fortunately, substantial refurbishment or reinvention is rarely necessary, as these centers are often more than 90 percent occupied by stable businesses that have successfully navigated the pandemic and adjusted to the growth of e-commerce.

Local expertise is essential for sourcing and managing these opportunities. Having professionals on the ground is critical for deal sourcing and asset oversight. Managing a shopping center in Leipzig from London, for instance, presents significant challenges.

With a presence in eight European countries and €110 billion in assets under management – including assets we service for over 200 European banks – we can locally source these opportunities. In some cases, as a result of our credit servicing relationships, we are a logical buyer.

Q To what extent have omnichannel retail strategies stabilized and become the norm for European retailers?

E-commerce penetration in Europe will continue to grow, likely providing further benefits to the logistics sector. However, no retailer with a physical presence would claim that their stores are not essential to their business. In well-tenanted shopping centers with successful retailers – particularly in middle-income areas – in-store sales are also on the rise.

> *"Retail has been underinvested institutionally for quite some time, creating room for greater exposure in investment portfolios"*

Omnichannel retailing has firmly established itself as the standard approach for selling goods, with physical stores playing a vital role. Beyond serving as direct sales points, stores function as hubs for order pick-ups and returns, reinforcing their importance in the retail ecosystem. The types of centers we acquire are less vulnerable to e-commerce disruption than high-end shopping malls, where stores often serve more as showrooms for products that consumers later purchase online.

Q How does the European retail market's adaptation compare with markets in North America?

At the onset of this period of retail market disruption, continental Europe was over-rented but never significantly over-retailed. The UK, however, experienced both over-renting and, to some extent, over-retailing.

By comparison, the US was drastically over-retailed due to decades of overbuilding. Even before the rise of e-commerce, many enclosed malls in the US were already in decline. The retail footprint simply became too large. However, high-end malls and open-air centers in affluent areas with strong demographics continue to perform exceptionally well, largely because there has always been a direct and transparent link between sales and rents.

In the UK, rents were typically based on valuers' estimates of rents rather than turnover, and retailers often signed long leases with upward-only rent reviews. This structure created significant challenges for retailer viability and asset liquidity.

The European market, in contrast, suffers less from excess space and is more fragmented. Rather than relying on flagship regional malls or numerous small grocery-anchored centers, continental Europe has multiple small, enclosed malls that combine grocery stores with a few additional retail outlets.

In both the US and, to some extent, the UK, large shopping centers often allocated a significant portion of their space to department store anchors, limiting landlords' ability to control every aspect of their centers. This dynamic is far less common in Europe, particularly in the types of assets we invest in.

Q Looking ahead, what are the key themes that will underpin equity investments in the retail sector?

Throughout time, there have been periods when certain asset classes were questioned for their long-term viability. However, physical stores have demonstrated remarkable resilience – weathering major structural shifts in consumer behavior as well as a global pandemic. This resilience restores investor confidence and encourages a fresh perspective on retail assets.

Offices are currently undergoing a similar reassessment. While some markets may have an oversupply of office buildings, capital is expected to return to high-quality assets over the coming years.

In the retail sector, this capital resurgence will likely begin with the types of assets we are acquiring. Over time, we may also see renewed investor interest in large, dominant regional malls. Investors will increasingly focus on specific segments of the market that align with their capital strategies during a particular window of opportunity.

As real estate ownership has become more institutionalized, investors have moved toward segmenting assets based on their risk-return profiles – whether prioritizing value appreciation, cash-flow stability or other factors.

The industry has recognized that commercial real estate, and even individual sectors within it, cannot be evaluated with a broad brush. This nuanced perspective is a positive shift, allowing investors to tailor their portfolios to best suit their strategies and market conditions. ■