MIDDLE MARKET Growth

Private Equity Sees Profit Potential in U.S. Malls

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By Myra Thomas

To say that the American mall is dead is a gross exaggeration. While many shopping centers across the country are struggling, so-called Class A mall real estate, typically in densely populated major metropolitan areas with attractive demographics and innovative concepts, is doing well and piquing investor interest.

While the shopping center of the past was largely dependent on large, well-known retail anchor stores, today's mall developers are retrofitting space to become lifestyle hubs, relying on a mix of fine dining, entertainment, hotels, offices, health care providers and retail, among other concepts, to help generate traffic.

"There are more upscale restaurants and more activity in malls today," says James Cassel, chairman and co-founder of Cassel Salpeter, a Miami-based investment banking firm. "Malls have to change to bring people through the doors to help out their other tenants."

Brookfield Asset Management's $14.8 billion takeover bid for publicly traded General Growth Properties in November made it abundantly clear that Class A malls are still in vogue. The following month, Australia-based mall owner Westfield Corp. disclosed that it was looking at a "potentially significant" corporate transaction.

While only 20 percent of malls qualify as Class A, they account for 72 percent of mall sales, with the top 10 in the U.S. averaging more than

$1,000 per square foot, or 2.5 times the industry average, according to data from Fung Global Retail & Technology.

As they evaluate opportunities, investors are doing more legwork before taking on projects, looking closely at population trends and lease terms, says Greg Ross, national managing partner for the construction, real estate, hospitality and restaurants industry practice at accounting firm Grant Thornton. According to historical deal volume data from real estate research firm CoStar, private equity investment in U.S. malls in the past decade peaked in 2015, and 2017 appears to have had significantly less activity, though numbers are still being compiled.

"The focus for private equity is on major metro areas," Ross says. "Location is the key."

Location, Location, Location ... and Creativity

The creativity of developers is as important as location as innovative retailers look for ways to compete with online sales, says Ronald Goldstone, senior vice president of NAI Farbman, a suburban Detroit-based real estate developer and brokerage. And that means coming up against 1970s zoning laws that don't take into account the more sophisticated, mixed-use plans of today.

Despite complicated ordinances, repurposing must happen without delay, says Steve Agran, managing director at New York-based investment bank Carl Marks Advisors. "They've got to view (a property) as something they can turn around in a short period of time—something they can monetize quickly," he says, adding that PE investors simply can't afford to sit on large real estate holdings.

Agran contends that the shopping mall needs to foster a sense of community, incorporating residential space into the commercial mix. "We have a complete upheaval in the industry, and we are running up against (retail) overcapacity ... so we're seeing heavy-duty repurposing, whether it's a car dealership in a section or housing and condos above ground," he says.

Paul Laudano, chair of the real estate department of Boston-based law firm Choate Hall & Stewart LLP, notes that the shifts in retail are not a brand-new phenomenon. "These are gradual trends, and it is a fair hypothesis that the better-located and more flexible assets will survive just fine in the foreseeable future," he says.

Choose Wisely

High-end malls are attractive to investors for their revenue potential, but the most deeply discounted real estate assets lie outside major metropolitan areas. Many remaining malls in the United States, especially those in rural areas, have seen a drop in sales, as their anchor retailers, such as Sears, Macy's and JCPenney, shutter stores.

"Everyone is certainly talking about anchors going away and the need to completely reposition regional malls," Laudano says.

Despite lower levels of private equity activity, mergers and acquisitions of mall real estate are trending upward, according to JPMorgan Chase & Co.

"There is increased activity globally in the regional mall space in the form of mergers and acquisitions, shareholder activism, and buying from well-known value investors," the bank wrote in a note, reported by *Bloomberg*, before Westfield's announcement. "This activity reflects a sector trading at a material discount to fundamental valuations."

The Private Equity Advantage

Filling space left by a massive anchor store can be challenging but not insurmountable, says Joshua Harris, academic director and clinical assistant professor of real estate at New York University's Schack Institute of Real Estate. He points to the addition of a Xerox SunPass customer service center and a Bed Bath & Beyond commerce call center at the lagging West Oaks Mall in the Orlando metropolitan area; department stores Sears and Belk had vacated the property, which is now owned by private equity firm Moonbeam Capital Investments.

According to Harris, private equity players have an advantage. "They don't have quarterly reporting requirements, and they have the free cash needed to do rehabs and conversions, and to change the configuration for new tenants," he says. "Private equity is looking for deals, but it's very individualistic."

It takes the right spot, the right government incentive, and the right people to make the repurposing work. Once a big retailer goes under, that's when a value-oriented investor can come in, add capital, and turn a property around, he says.

"For a mall to work, it has to be all about innovation—delivering on experience, whether it's concerts, spas, consumers going hands-on in an Apple store, upscale dining," says Grant Thornton's Ross. "In the past, the retail anchor was the thing. Now malls have to rebrand as family and entertainment centers."