

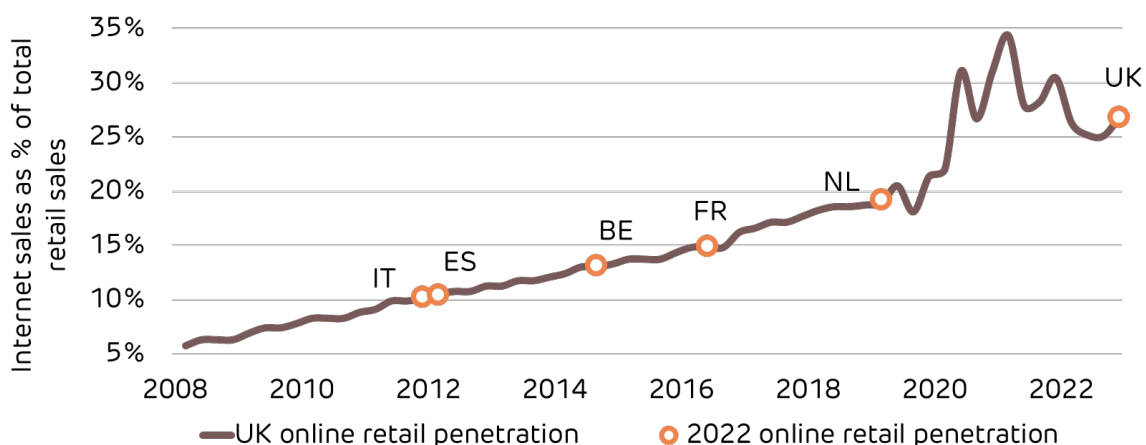
THE OPPORTUNITY IN EUROPEAN LOGISTICS

We have written [previously](#) about the opportunity we currently see in mainland European logistics real estate. Our thesis is simple. On the margin, demand for logistics real estate is now primarily driven by the growth of e-commerce and omnichannel retail. This is why logistics real estate in places like the UK—where the domestic e-commerce market has expanded rapidly for about 10 years now—enjoyed nearly a decade of outperformance. European e-commerce markets, on the other hand, have matured at a slower pace. As a result, so too has logistics real estate in mainland Europe. However, European e-commerce penetration has finally started to accelerate, and we expect that it will increasingly catch up with the UK over the next 5-10 years. As it does, logistics real estate in Europe should see robust demand growth, comparable to the growth enjoyed by logistics real estate in the UK during the last decade. This should deliver substantial rental growth in turn, particularly given the constraints on new warehouse supply across Europe.

In short, attractive long-term fundamentals—combined with some recent cap rate expansion, driven by interest rate hikes during the past 18 months—create a compelling opportunity in European logistics today.

We can sharpen this thesis with some data. As Figure 1 shows, most mainland European countries still lag the UK by several years with respect to the maturity of their e-commerce markets. The rate of e-commerce penetration is 27% in the UK, compared with 21% in Germany, 19% in the Netherlands, 15% in France, 13% in Belgium, and 10% in both Spain and Italy.¹ As we noted above, due to slower e-commerce growth on the continent, logistics real estate in mainland Europe has generally underperformed logistics real estate in the UK. Until 2021, logistics take-up volumes had remained roughly flat since 2017 in France, Germany, and Spain. Alternatively, in the UK, annual logistics take-up doubled over that period.² Similarly, logistics rents across mainland Europe remain substantially cheaper than logistics rents in the UK. (See Figure 2.)

FIGURE 1. EUROPE LAGS THE UK WITH RESPECT TO E-COMMERCE PENETRATION³

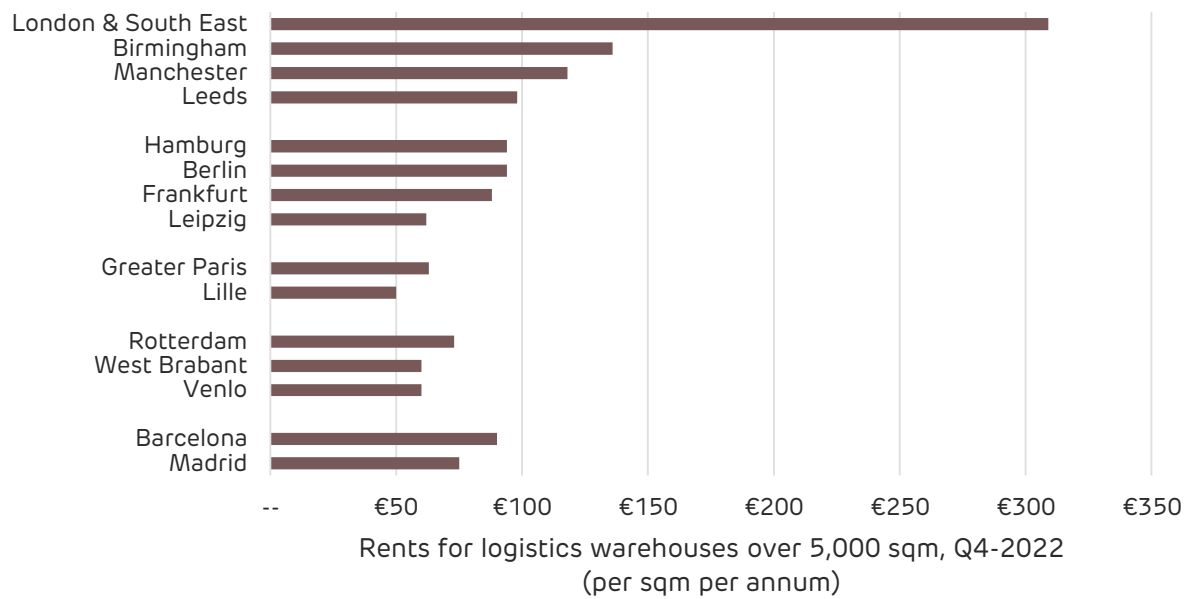


¹ Savills

² Savills

³ Savills

FIGURE 2. LOGISTICS RENTS: UK VS. MAINLAND EUROPE⁴



There are several possible explanations for the sluggish growth of European e-commerce. For one, compared to the UK and the US, European economies are generally less dynamic and slower to adopt new technologies. As a result, it simply takes longer for many secular trends to take hold in Europe. There are also cultural differences. In some European countries, like Italy and Spain, older consumers have a stronger attachment to in-person shopping. Their resistance to e-commerce has likely slowed its growth. Perhaps most importantly, American e-commerce giants like Amazon typically chose to expand into Europe by starting in the UK. This early wave of investment gave the UK a head start, by providing it with logistics infrastructure that could facilitate e-commerce at an efficient scale. Conversely, major e-commerce firms largely did not make early investments of a similar magnitude in Europe. This delayed the development of Europe’s e-commerce market.

Ultimately, however, these gaps should not persist. Mainland Europe is structurally similar to the UK in most of the ways that matter for e-commerce: its countries are advanced, consumption-driven economies with near-universal internet access and high levels of urbanisation (often concentrated in a small number of dominant cities, allowing for relatively efficient delivery networks). With that structural landscape in place, e-commerce should eventually be capable of delivering the same benefits to European consumers that it has already delivered to consumers in mature e-commerce markets. As Europeans change their consumption habits to reflect the advantages of e-commerce, e-commerce penetration in Europe should converge with e-commerce penetration in the UK.

For those benefits to materialise, though, some obstacles must be overcome. The largest obstacle is Europe’s underdeveloped logistics infrastructure. While the UK has about 30 sq ft of industrial stock per capita, Germany has about 20 sq ft, and France and Italy each has about 10 sq ft. Without dense delivery networks and scaled-up logistics infrastructure, e-commerce is neither efficient for sellers nor attractive to consumers (at least without significant subsidies). At the same time, e-commerce firms are often reluctant to invest in large-scale logistics infrastructure if they do not see tangible consumer demand. This creates a kind of trap, where logistics infrastructure will remain sub-scale until consumer demand is strong, but consumer demand will also fall short of its potential until sufficient infrastructure is built. Some type of shock—either on the demand side (e.g., via a forced surge in the volume of online sales, like what happened during the pandemic) or on the supply side (e.g., via a company electing to take a big bet on a new market)—is needed to break out of that

⁴ Castleforge analysis of BNP Paribas and CoStar data

equilibrium. Once it breaks, the flywheel starts to spin: more e-commerce sales generate more infrastructure investment, which lowers costs and improves the e-commerce experience for consumers, leading to even more e-commerce sales and, in turn, more infrastructure investment.

Within the last couple of years, that flywheel has started to spin for European e-commerce. Since 2019, e-commerce growth in most European countries has outpaced e-commerce growth in the UK. While e-commerce sales grew at a CAGR of 12% in the UK between 2019 and 2022, e-commerce sales expanded at a CAGR of 17% in the Netherlands, 15% in Italy, 14% in Germany, and 13% in France.⁵ Meanwhile, multinational e-commerce firms increasingly recognise mainland Europe as an underpenetrated market with significant potential for further growth. They now have plans to invest accordingly. In May, Amazon's head of operations for North America and Europe announced that the company plans to grow its European warehouse footprint over the coming several years. Similarly, the president of Alibaba recently unveiled plans to expand the company's operations on the continent, saying that "Europe is a top priority for [Alibaba's] international commerce business, the cloud business, and the logistics business in particular". Carrefour, the world's eighth-largest retailer, aims to reposition itself as a full-blown "Digital Retail Company" by 2026, by investing €3 billion in e-commerce capabilities over the next three years. All told, these programmes should further accelerate the growth of European e-commerce.

As Europe's e-commerce markets mature, logistics real estate across the continent will be a major beneficiary. A simple comparison of the UK and French markets illustrates the potential magnitude of this opportunity. The rate of e-commerce penetration in France stands at 15% today. In the UK, e-commerce penetration reached 15% seven years ago, back in 2016. In 2016, market rents for UK logistics space were £5.33 per sq ft. As it happens, logistics rents in Greater Paris hover around a similar level today, at €5.85 (£5.01) per sq ft. Between 2016 and 2022, as e-commerce penetration increased from 16% to 27% in the UK, logistics rents grew by 54%, from £5.33 per sq ft to £8.22 per sq ft.⁶ It is perhaps too simple to infer that if e-commerce penetration expands in a similar way in France over the next several years then logistics rents in Paris will therefore follow the exact same trajectory. Still, at least directionally, that conclusion seems right: we should expect significant growth.

To be sure, underlying land values differ across these countries, as do vacancy rates. (Although it is worth noting that the vacancy rate for French logistics space is about 3% currently, lower than the 2016 vacancy rate of 4.5% for logistics space in the UK.) In addition, some markets will face tighter constraints on new logistics supply than others. But Paris—or, for that matter, Madrid or Rome—could hardly be described as an open field of buildable land compared (for example) to Leeds, where logistics rents currently exceed rents in Paris by about 35%.⁷ Even if it is impossible to predict where exactly European logistics rents will ultimately land, meaningful catch-up growth is likely. As that happens, European logistics real estate should outperform.

RISING TIDES DON'T LIFT BOATS WITH HOLES: LESSONS FROM DATA CENTRE DISTRESS

A recurring theme in our letters is the idea that what's true of something as a whole is not necessarily true of each constituent part. In the specific context of real estate, structurally challenged sectors typically contain well-positioned subsectors, and even struggling subsectors usually contain individual assets that outperform the wider market. We often apply this idea to the office sector. Although offices face secular headwinds as a whole, certain segments of the office market continue

⁵ Centre for Retail Research

⁶ Castleforge analysis of BNP Paribas and CoStar data

⁷ BNP Paribas

to enjoy strong demand fundamentals and tight supply constraints. Attractive opportunities often lurk in out-of-favour places, where investors have thrown the good out with the bad.

This idea has a corollary. Just as attractive corners of the market can be found in sectors beset with secular headwinds, sectors supported by tailwinds always contain plenty of losers, including unviable business models, subsectors in structural decline, and simply bad assets. Investing in these sectors can be particularly challenging because exuberance around future growth tends to paint with a broad brush, obscuring the differences between the good business models, subsectors, and assets and the bad ones.

Over the past year, the data centre sector has supplied a few examples that illustrate how things can go wrong even when you have some long-term tailwinds on your side. Cyxtera Technologies is the latest such case.

Cyxtera is the largest global provider of retail colocation services, operating 65 data centre facilities across 33 markets. (Colocation providers effectively rent out data centre capacity and equipment to multiple customers within a given facility.) The Florida-based company was formed in 2017 via a PE-led carve-out of CenturyLink's colocation business and, in 2021, effectively went public in a de-SPAC transaction that raised about \$650 million. Barely two years later, on 4 June, Cyxtera filed for Chapter 11 bankruptcy.

What happened? Here is one version of the events, according to Cyxtera's bankruptcy filing:

Despite its strong core business performance, the Company has recently faced significant headwinds from inflation and macroeconomic volatility, which have driven up interest rates and energy prices. [...] These challenges, along with the impending maturity of the Company's revolving and term loans, placed increasing pressure on Cyxtera's capital-intensive business, straining the Company's liquidity profile and ability to invest in the business.

Energy items comprise a substantial portion of Cyxtera's cost structure, as they do for most data centre operators. Unlike many of the company's competitors, however, Cyxtera had declined to substantially hedge its energy costs. Since 90% of Cyxtera's sales derive from fixed-term (and generally three-year) contracts, the company could not immediately pass higher energy costs through to its customers, either. That apparently led to a deterioration in Cyxtera's operating performance.

This aspect of the story underscores an obvious lesson: real estate investors with concentrated exposures to energy-intensive tenants (e.g., owners of single-tenanted buildings leased to data centre operators or cold storage providers) need to understand the extent to which those businesses can control, or immediately pass through, their energy costs. If their ability to do either is limited, the landlord should, at minimum, ensure that it gets compensated for the risks associated with leasing an entire building to a tenant that lacks visibility over its own supply chain. Otherwise, the landlord ends up subsidising a heads-I-win-tails-we-both-lose proposition. If energy prices drop, the unhedged operator may capture some additional short-term profits, but the landlord gains nothing. If energy prices shoot up, and the operator's business blows up in turn, the landlord probably loses, too. This is not a good trade.

More important than the problem of rising input costs, Cyxtera was saddled with a significant debt load, tracing back to the 2017 carve-out. This finally became unviable, given higher interest rates, looming maturities, burdensome capex requirements, and—contrary to the explanation provided by the Chapter 11 filing—the questionable performance of Cyxtera's core business.

Although the data centre operator used SPAC proceeds to pay down some debt in recent years, Cyxtera's pre-petition balance sheet held about \$1 billion of financial debt obligations, all floating-rate and all maturing sometime in 2024. (This excludes an additional \$1.4 billion of lease liabilities—

more on this later.) As interest rates increased over the last 18 months, Cyxtera’s annualised interest expense on its financial debt reached \$76 million in Q1-2023, up from \$36 million in Q1-2022. At the same time, Cyxtera has persistently run free cash flow deficits, largely due to its significant ongoing capex requirements: last year, the company did ~\$300 million of so-called “transaction-adjusted EBITDAR” and spent \$214 million on lease payments and \$135 million on capex. In short, Cyxtera could no longer service its debt while continuing to pay the rent and fund necessary capital improvements.⁸

The dynamics at play here recall [observations we have made in the past](#) about some of the “asset-light” flexible office operators, like WeWork. Similar to many of their business models, Cyxtera’s business operates by borrowing long and lending short—specifically, by taking “long-term, non-cancellable” leases on entire data centres and then effectively subleasing capacity at higher rates for shorter terms. This business model is inherently leveraged, particularly when the operator’s leases are tied to parent-company guarantees and lack break options. Indeed, even though Cyxtera’s data centres were significantly underutilised—the company-level capacity utilisation rate stood at about 71% in 2021, about 10 percentage points below most of its peers’ utilisation rates—Cyxtera generally could not trim costs by exiting underperforming facilities. As a result, the company had little ability to control the timing of its capex: in order to meet rent obligations, Cyxtera needed to lease up vacant capacity, and this required spending money to improve that capacity. (Thus, even if some 84% of Cyxtera’s \$135 million 2022 capex bill was not strictly for “maintenance” purposes, as the company says, much of that spending was no less discretionary in practice.) Operating leverage is a double-edged sword.

Some of Cyxtera’s landlords are now left with a mess. Since Cyxtera’s leases (unlike WeWork’s) were typically signed or guaranteed by the parent, Cyxtera’s landlords were partially shielded from the risks of the company’s leveraged operating model. But only up until a certain point, particularly given Cyxtera’s debt load. (Plus, considering that the company has never turned a profit and leases much of its data centre equipment, even if its landlords weren’t behind a long list of creditors, one should have wondered about the value of those guarantees in the first place.) In any event, Cyxtera will presumably now use the bankruptcy process to exit some of its worst-performing and most underinvested-in facilities, leaving their owners with assets that are probably unleaseable without substantial upgrades. One of those owners is Digital Core REIT, which derives more than a fifth of its revenues from Cyxtera. Digital Core’s stock has now lost about half of its June 2022 value.

This points to a final lesson. A data centre wholly leased to a non-credit operator is not similar to an office or retail building leased to multiple non-credit tenants, where diversification at the building level mitigates some of the tenant-specific risk to the landlord. This problem is not solved by having a diversified base of end users at the building either. Indeed, no amount of customer-mix diversification would have fixed Cyxtera’s (and thus its landlords’) problems, which mainly involved the company’s capital and cost structures. Instead, the fundamental question for investors in these types of buildings is whether the tenant (or guarantor) will be capable of paying rent for the duration of its lease term (and thus potentially across multiple business cycles) given the various competing claims on its cash over that period, including those stemming from its debt obligations, equipment leases, and capex requirements. An operator like Cyxtera—unprofitable and significantly indebted with a lot of operating leverage and large capex requirements—would probably never have passed this test.

⁸ At this point, Cyxtera had also run out of fundraising options. Unlike some of the company’s peers, which have recently raised funds by selling assets, Cyxtera could not access much liquidity by selling real estate, since it leases most of its data centres. Not surprisingly, refinancing proved infeasible under these circumstances, too.

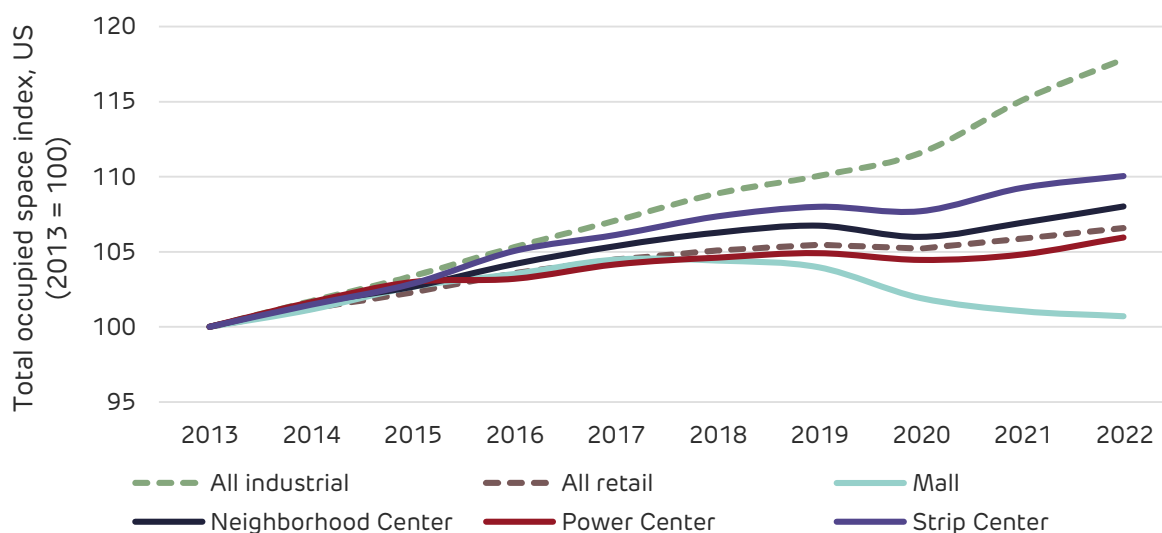
THE WINNING POCKETS OF RETAIL REAL ESTATE

Readers are probably familiar with the so-called “retail apocalypse” narrative: during the last decade, e-commerce pushed shopping activity out of brick-and-mortar stores, destroying demand for traditional retail real estate. At the aggregate level, this narrative is correct. Average same-store NOI growth for all US retail REITs was about 11% between 2015 and 2023, markedly below cumulative inflation for that period. (For regional mall REITs, this figure was even more anaemic, at just 5%.) By contrast, over that same period, industrial REITs saw 48% same-store NOI growth, residential REITs saw 40% growth, and office REITs saw 28% growth.⁹ This fall-off in demand for retail space had a pronounced effect on property values, particularly in the middle and lower quality segments of the market: by 2021, capital values for B-quality retail buildings were more than 10% below their pre-GFC peak, while capital values for similar-quality industrial buildings were more than 80% above their peak.¹⁰

Although the “retail apocalypse” narrative contains general truths, it omits important details. Most notably, it glosses over the considerable variation in performance that one finds within the broad category of retail real estate. In fact, by several different measures of underlying supply/demand fundamentals, the gaps between the various subsectors of retail real estate have roughly matched the gaps between the retail and industrial sectors at large.

For example, Figure 3 charts the growth of total demand (as measured by occupied space) for industrial and retail real estate in the US between 2013 and 2022, with separate series for four retail subsectors. Over that period, demand for industrial space expanded by 18%, exceeding demand growth for all retail space by 11 percentage points. At the same time, however, the best-performing retail subsector by this measure (strip centres) saw demand growth of 10% during the last decade, while the worst-performing retail subsector (malls) saw demand growth of just 1%, representing a gap of nine percentage points. Although no retail subsector outperformed industrial by this measure, the “retail apocalypse” narrative does not hold across the board either. Certain pockets of the retail market have at least held up.

FIGURE 3. DEMAND FOR RETAIL SPACE BIFURCATED OVER THE LAST DECADE¹¹



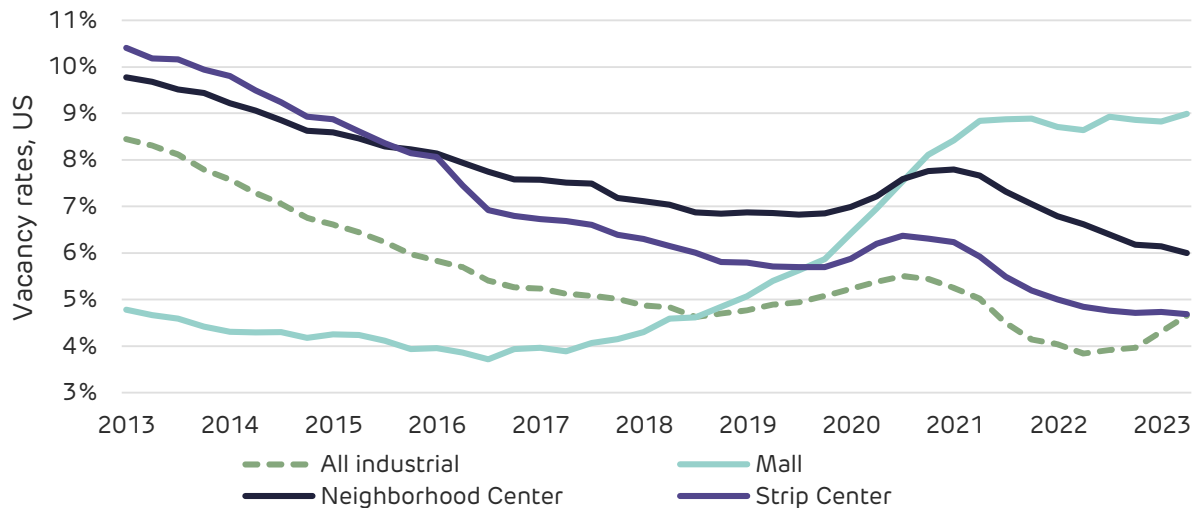
⁹ Castleforge analysis of NAREIT data

¹⁰ Green Street

¹¹ Castleforge analysis of CoStar Data

Vacancy rates depict a similar trend, as Figure 4 shows. On the one hand, vacancy rates for US malls nearly doubled over the last decade, from 4.8% in 2013 to 9.0% in 2023. Over the same period, vacancy rates for industrial properties roughly halved, from about 8.4% to about 4.7%.¹² Even though strip centres, like malls, belong to the wider retail sector, strip centre vacancy rates have looked more like industrial vacancy rates than mall vacancy rates in recent years, with respect to both trajectory and absolute level. Indeed, with the exception of a brief uptick during the pandemic, vacancy rates for US strip centres have steadily declined since 2013. They now sit below 5%, almost exactly on par with current vacancy rates for industrial properties.¹³ (Even more, strip centre vacancies dropped to that level from a much higher 2013 base than industrial vacancies.)

FIGURE 4. US STRIP CENTRE VACANCY HAS CONVERGED WITH INDUSTRIAL VACANCY¹⁴



In fact, these figures probably understate the true strength of the last decade’s best-performing retail segments, which were likely niche subsectors for which only limited data are available. This includes “grocery-anchored” shopping centres, medical retail buildings, and many net leased properties (including, for example, drive-throughs and standalone restaurants), almost all of which have enjoyed record levels of investor demand in recent years.

If there is a pattern here, it shows that the retail subsectors that outperformed over the last decade generally did so in one of two ways: either by being resistant to the growth of e-commerce or by positively benefitting from it. On the one hand, certain forms of consumer spending largely have not, or cannot, move online—for example, haircuts, medical procedures, and restaurant meals. This helps explain the outperformance of strip centres, which typically contain the services-oriented, small-business tenants that consumers have continued to transact with in-person. On the other hand, e-commerce also created outright tailwinds for some retail subsectors. For example, the growth of online grocery shopping has enhanced the value of many brick-and-mortar grocery stores, since these buildings now effectively double as last-mile distribution centres to fulfil online orders. In other cases, online shopping has actually complemented in-person shopping, not substituted it. For example, more than a quarter of Starbucks’s orders are now placed online, even though most of these orders then get “fulfilled” in-person at the company’s brick-and-mortar stores.

The lesson is that macro trends play out in subtle ways. Thus, it is a mistake to overgeneralise. A headwind that afflicts a particular sector at the aggregate level could simultaneously represent a

¹² CoStar

¹³ CoStar

¹⁴ CoStar

tailwind for some of the segments within that sector. The details matter, and investors should pay attention.

WHEN WEWORK HANDS BACK THE KEYS: AN UPDATE ON 125 SHAFTESBURY

Mike came up bust on his tiny personal bet on WeWork shares, at least for now. It was always going to be a completely out-of-the-money option on the office market, and that option has probably expired still quite far out of the money. (Ever the optimist, Mike is quick to remind the rest of us that until WeWork actually “goes bk” that option still has some “t” left in it—good luck with that, Mike.) The company claims that the US return to office has been slower than expected, and that large amounts of portfolio vacancy are weighing heavily on its P&L. In the end, perhaps Mike can be comforted by the fact that well-known global investment managers probably lost a lot more.

However, we’re not buying the “return to office” story as the primary reason for the troubles behind some of WeWork’s offices, specifically. After all, many of WeWork’s leases are set up in SPVs with little if any guarantee remaining from the parent company. Instead, we think the WeWork business model—which obsessed over what the company termed “enterprise clients” for the sake of satisfying public market perceptions of tenant credit—was at the root of breakdown.

Case in point: 125 Shaftesbury Avenue. We have been following the office building for several years now, having first written about it in our [September 2017 research letter](#), where we cited 125 Shaftesbury as one of many WeWork-occupied buildings that were distorting the London office market.

The building has a bit of a sensational history. Back in 2018, just prior to the acquisition of the property by a group of investors from a London-based developer for £267 million, WeWork agreed to lease the entire office portion of the building until 2038, at an average annual rent in the mid-£70s per square foot. As it often does, WeWork used a special purpose entity for the lease and provided, at best, an extremely limited corporate guarantee. WeWork would have put in very little if any capital into the project, with virtually all the fit-out works having been paid for by the TI package provided at lease signing. Then, WeWork immediately leased the entire office space to a sole occupant—Facebook (now Meta)—and claimed that this sub-lease to a credit occupier proved WeWork’s own creditworthiness.

Never mind that the lease to Meta was only for a few years, and that even then, WeWork provided a considerable upfront discount to Meta and a significant cash payment to the leasing agents. Just how much cash WeWork actually collected from Meta is debateable, but it would not have been even close to its own liability as lessor. As Mike is fond of saying, “Just because Warren Buffet stays in our Best Western Plus in Edinburgh for a few nights doesn’t mean that the hotel is any more valuable.” As we said in our 2017 letter, it isn’t the credit of WeWork’s sub-tenant that matters but rather “the ability of the WeWork SPV having taken the lease to cover its cost basis (i.e., rent level) throughout the ups and downs of the real estate and economic cycles.”

After just a few short years, Meta’s contract with WeWork expired, and the social media company vacated 125 Shaftesbury to move into its new headquarters in King’s Cross. As we anticipated in [our 2019 letter](#), shortly after Meta’s departure, WeWork proceeded to throw the keys back to the building’s owners, leaving them with entirely empty office space in a building that requires a major refurbishment and substantial re-leasing costs. Instead of collecting 20 years of stable income, investors find themselves stuck with a building that will generate income again only after millions of pounds of capex and risk mitigation.

This was not a project that the building’s investors were willing to undertake: 125 Shaftesbury is back on the market now, this time at an asking price of £175 million. As we have suggested in the past, this

building should never have been regarded as a safe, core investment in the first place. It was evident at the outset that, if Meta were to leave, WeWork would have no reason to maintain its lease. (As we wrote in 2019, considering that “WeWork [...] has 60 locations in London, some across the street from the other,” “virtually none of the real estate is individually mission-critical to the operator.”) And if WeWork were to leave, it was clear that 125 Shaftesbury would be difficult to re-lease at all, and virtually impossible to re-lease at similar rents. The 11-storey 1980s-built office building with limited green or employee wellness credentials is precisely the type of office that blue-chip occupiers no longer want to lease until someone completely transforms it, which is now likely to happen, although the next set of value-add investors will require a substantially reduced basis from which to undertake that business plan.

Michael Kovacs



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Adam MacLeod



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Evan Garnick



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