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A With Intelligence Company

Real Estate Whitepaper

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Welcome to CAMRADATA's Real Estate Whitepaper

Real estate used to be the only real asset held by many pension funds. Nowadays it has to compete with many others, including infrastructure and private equity, to gain attention. This means real estate's role as a diversifier has changed, but for the good. There are now so many different ways to access the asset class.

Mature pension schemes want it more for income with links to inflation, which has led them into investments such as long leases and collateralised mortgages, not just owning property.

ESG-conscious investors are backing efficient new-builds and related infrastructure, as well as applying standards such as GRESB to existing buildings.

Newer sectors such as student accommodation, social housing, warehouses and data centres reflect secular economic trends. The question for asset owners here is which managers have experience and skills to capture the benefits of these emerging classes.

Then there is the nature of the investment funds. Listed real estate vehicles offer a ready way to gain exposure. That may prove appealing as write-downs on holdings in closed-end funds surface in coming months.

Real Estate fundraising has plummeted this year, with only $66.8bn raised in H1 compared to $159.5bn for the same period in 2022, according to PitchBook. While there remains plenty of dry powder on hand for direct investing, it is a tale of the current times that fresh capital for Core and core-plus has all but dried up. According to PitchBook, opportunistic strategies are the most popular strategy around.

Meet the Team

Natasha Silva
Managing Director, Client Relations

Amy Richardson
Managing Director, Business Development

Sam Buttress
Associate, Business Development

Sarah Northwood
Marketing and Events Coordinator

Orin Ferguson
Associate, Business Development

Real Estate Roundtable

The CAMRADATA Real Estate Roundtable took place in London in October 2023

The 2023 CAMRADATA Real Estate roundtable began by asking fund selectors and investment consultants about their clients' allocation to property.

For Redington, a consultancy to institutional investors with £600bn in assets under advice, James Sivyer, who focusses on real estate research, said clients had about 5% across the asset class in listed and unlisted; equity and debt.

Sivyer said that over the last 12 months, listed Real Estate has been "a challenging place to be" because it has borne the brunt of rate hikes and their consequences for funding. Market capital values had thus stabilized. "If we are at peak interest rates, REITs prices will be ticking up over the next few months," he said. Sivyer said some Redington clients could be upping allocations next year.

David Whitehead is an equity portfolio manager for Mediolanum International Funds, which manage about E50bn in assets under management on behalf of 1.7 million retail clients in Italy, Spain and Germany. He explained that approximately E8bn is invested in equity sector funds, but exposure to listed real estate across these funds is low - less than 2%. Whitehead noted that this is not too dissimilar to real estate's typical weight in main global equity indices. "Fund allocation is an outcome of the analysis done by our Family Bankers, taking into account the client's overall risk appetite, investment horizon and financial requirements," he said.

In contrast, Sarah Acheson, an investment director in the private client practice at Cambridge Associates, said Real Estate is categorised as a private diversifier alongside other real assets.

She explained that in many cases, private clients came from families which own large amounts of real estate already. Income from such estates meant these clients did not need additional exposure to core real estate. "They need to diversify away from that," said Acheson, "which means considering 'higher octane' value-add and opportunistic real estate, with 12-15% net returns, of which income is typically not a significant concern.

For XPS, Beatrice Stanoescu, head of research for private assets, said clients get listed real estate exposure through various diversified strategies (i.e. Diversified Growth Funds (DGFs), Diversified Private Markets Funds) and they are supportive of it featuring as a component of liquid growth strategies.

Stanoescu has done risk-return modelling using historical data going back 33 years; over this period, the analysis shows that adding REITs to an equity portfolio increases returns and reduces risk modestly.

> ***"On the issue of income versus capital appreciation, Sivyer said that Redington's corporate-sponsored DB plans tended to look at this asset class as a source of income, e.g. long leases."***

This overall showed a slightly more compelling case than listed infrastructure, with analysis based on a larger data set. The results found that a c.5% allocation to listed real estate in a liquid growth (global equity) portfolio was optimal on the resultant efficient frontier and this could benefit clients. A standalone

allocation would only really be justifiable where the equity allocation was greater than 50%. Of course, that could vary dynamically within a DGF or fiduciary mandate.

Steven Rodriguez, portfolio manager for real estate securities strategies at American Century Investments (ACI), asked Stanoescu whether she accounted for tactical changes, especially given where we are now in the economic cycle.

She responded that managers could definitely adjust exposures beneficially; it was a case of understanding leading and lagging behaviours of listed and private markets, so one could tactically allocate at different times across the two asset classes. The REITs market is increasingly a leading indicator. Private RE typically lags listed real estate due to its slower-moving price discovery and transactions. "The literature shows that REITs perform well at the transitioning of rate cycles, when rate-hiking cycles have ended," said Stanoescu. "A more stagnationary environment, when both growth and real yields are down, would benefit REITs, whereas in a stagflation scenario (low growth but higher yields), listed property would underperform. There's been stronger relative outperformance in early-cycle recovery periods when compared with private property."

But she warned that it is hard to time markets: "To benefit from an allocation, you have to be invested for longer. Private and listed real estate are correlated over the medium to long term, i.e. three to five years. Both experience fluctuations in the same direction over time, albeit private markets are slightly lagged and experience relatively smaller swings."

On the issue of income versus capital appreciation, Sivyer said that Redington's corporate-sponsored DB plans tended to look at this asset class as a source of income, e.g. long leases.

"But there is more demand right now for value-add and opportunistic," said Sivyer.

For XPS, Stanoescu said that from an income perspective, XPS would tend to look at Secure Income funds (which invest across a wide range of private credit & real assets); and that listed real estate was typically found within Long-Term Asset Funds (LTAFs) for DC clients as a liquidity sleeve, e.g. 70% private markets' exposure; 30% listed securities' exposure.

Whitehead said that, within the context of the bank's client base and looking specifically at the Real Estate Global Fund that they manage, real estate is not utilised as a source of income within client portfolios. This is a role is played by other Mediolanum fund solutions that have a clear income distribution objective. "Real Estate Global is seen as a capital appreciation solution more than a pure income provider," Whitehead said. "Given their place at the heart of the economy, real estate firms tend to be positively correlated with wider equity markets, so

> *There is an acceleration in the number of individuals getting to 80. From a supply perspective, the pandemic crisis and more recently higher capital costs put a freeze on starts for senior living accommodation. Since then, rental rates and occupancies have gone up, which spells a lot of income growth."*

they do not hold up significantly better when equities are in broad decline."

On the mix of capital appreciation and income, Andreas Welter, senior portfolio manager in global real estate for Van Lanschot Kempen (VLK), reckoned that listed real estate will deliver almost 10% return per year net of all costs going forward, half of which will come as income. This return for mainly core properties compared favourably to the more risky opportunistic strategies mentioned by Acheson. He urged consultants and fund selectors to consider a standalone allocation.

Chris Jeffs, fund manager for the M&G Shared Ownership Fund, said that his clients such as local government pension schemes invest through economic cycles, so it is income that they are most interested in. Right now, they were extending inflation-linked cashflows. He agreed with Sivyer that, nonetheless, there are value-added opportunities waiting round the corner.

"There has been repricing in the real estate market across the board," said Jeffs. "It's more obvious in value-add but it's there in core too. The challenge is gearing and the kind of finance you need. Real estate debt is very attractive right now because you can get equity-like returns through debt."

Sivyer said that for the last decade, it has just been beta risk: levering up the deal. "Now that is over, debt, financing rates mean you need more stockpicking skills. It is the bread and butter of any proper real estate investment manager. It's painful but necessary to get out the other side."

Rodriguez said that REITs had experienced under-performance given the economic cycle and where inflation is. "But the tide has clearly gone out. We are expecting many private real estate vehicles to re-capitalise in 2024 given their elevated leverage and pressure on valuations with the listed real estate markets having already experienced -30% since the end of 2021. So you need to focus on balance sheets and re-capitalisations."

His argument was that REITs are better financed. "The catalyst is going to be better vision around the Central Bank's tightening cycle. Then we are going to see companies with better balance sheets grow extensively."

The Spur of Artificial Intelligence

The managers on the CAMRADATA panel then spoke about their preferred sectors.

For ACI, Rodriguez started with data centres globally, which have enjoyed strong growth for a decade, but generally weak organic growth. Like-for-like organic growth has, however, dramatically improved over the past 12 months. "There is a lack of space given less power availability in many global markets, coupled with a surge of investment into Artificial Intelligence," he said. "This has added another 15-20% to demand, resulting in a pull forward of demand with rental rates being up 20-30% year-on year."

Rodriguez's second theme was the US single family rental sector, where he saw a long-running undersupply of affordable housing: "The trend has been for families moving from the city out to suburbs to get more space."

His third sector was senior living. "We are very optimistic because of the demand profile," he said. "There is an acceleration in the number of individuals getting to 80. From a supply perspective, the pandemic crisis and more recently higher capital costs put a freeze on starts for senior living accommodation. Since then, rental rates and occupancies have gone up, which spells a lot of income growth. There are tons of tailwinds to this sector."

For VLK, Welter agreed with much of what Rodriguez said. He said that it was easy but erroneous to sit in a European city and extend local problems to the wider world. Instead, the reality is that Working from Home means little in countries like Australia and Japan, with consequences for the office markets in major cities there. Meanwhile, positive supply/demand imbalances exist in most living sectors in the US. Further in the US, Welter noted that rental growth will remain high for the Logistics sector in the years to come.

On the listed sector overall, Welter explained that leverage for REITs was near historic lows, down from average Loan-to-Values of 50-60% leading up to the Global Financial Crisis to more like 30-35% today. Welter reiterated the ability of most real estate sectors to include inflation rises in rent renewals. He expected inflation to come down and normalise further over the 12-18 months, "which is not a bad thing for the listed sector."

On data centres, Sivyer said that the challenge, especially for ESG-minded asset owners, is power consumption. He asked the managers at the CAMRADATA Real Estate roundtable how they squared attractive financial prospects with heavy energy usage. Welter replied that ESG was a main focus for VLK. "For investee companies with a deep carbon footprint, such as Equinix, we will engage." Welter said VLK pushed for short, medium and long-term targets from investee companies. It also expected these goals to be tied to the individual remuneration of senior managers.

Rodriguez said that ACI analysed data centre operators with regard to material benefits and risks. "There is a high risk with data centres if they don't have access to renewable energy," he said. "It's paramount to executing their business model."

He noted that Digital Realty had improved the percentage of renewable energy it used from c.40% three years ago to 65%. The results for Equinix were "more nuanced" because on paper the increase is from 50% to 70% over the same time period, according to ACI's research. "Equinix itself claims near 100% but that is achieved by means of carbon credits. ACI doesn't count them and encourages the company to invest more directly in energy sustainability solutions," said Rodriguez.

Like Welter, Rodriguez acknowledged the roles of engagement but also greater regulation in these changes. Nothing is perfect. Jeffs noted that the European Union's Sustainable Financial Disclosure Regulation (SFDR) wasn't great on transitioning assets. "Progress from data centres cannot qualify under SFDR," he said. "It blacklists transitioning assets even when backing them is the most impactful thing we can do."

He added that when it comes to ESG, current standards in the UK for new builds are poor too. In practice, M&G is focussing on single-family housing over flats for its Affordable Housing strategy, resembling the sector trend noted by Rodriguez and Welter in the US.

Jeffs explained that succeeding in operational real estate was difficult without scale. "This is what the Build-to-Rent (BTR) sector has found in the UK. If you only have 200-300 properties, you will struggle." Jeffs claimed affordable single family housing has some operational benefits over BTR.

M&G keeps a direct, contractual relationship with its customers, which requires good levels of governance, according to Jeffs. He contrasted this with the model wherein investment managers contract with Housing Associations, which then hold the relationship with residents. "Shared ownership is most interesting," he said. "There are huge social benefits and different risk characteristics when you hold the direct relationship."

M&G also has a senior living exposure as part of its Balanced Funds. "In the UK we have a lack of good quality senior living housing," said Jeffs. M&G, however, has chosen not to go into full-time care accommodation. Instead, it is targeting 65-85 year-olds who need a secure abode with better access to healthcare – "a massive requirement."

It has been a traditional aspiration in the UK to buy your own property. "But when the children have grown up and moved out, what do you do with the empty nest?" asked Jeffs. "The M&G strategy helps right size residential property."

He added the UK has yet to "master" affordable housing. M&G has entered the market targeting homeowners who can afford bespoke designed apartments and expect support from a skilled concierge.

Minority Efforts in Aggregate

The conversation on ESG deepened. The CAMRADATA panel was asked how minority shareholders can work together to give investee companies the right messages in the best way.

Rodriguez said that the single-family rental sector 15 years ago was predominantly a small-scale "mom & pop" business. "Even five to seven years ago there was no sustainability disclosures. It took questions by multiple stakeholders, including institutional investors, to familiarise that process," he said.

Welter added that there had been no disclosure on sustainability metrics from major players such as American Homes as recently as three years ago. "Now they have hired ESG teams which has ultimately has resulted in actual change."

Jeffs said that third-party audits, from the likes of the Sustainability Accounting Standards Board, and collaboration with consultancies such as Good Economy, was the way forward. "It goes back to regulation nudging ESG forwards." But he added that more cohesion would be a great help. Acheson agreed that markets are only going in one direction and was confident that there will be a standard.

Whitehead said Mediolanum portfolio managers are supported by the ESG team in engaging with investee companies. Depending on sectors and their specific sustainability risks and opportunities, the ESG team will provide tailored questions and areas for portfolio managers to cover with the investee companies. He described it as a journey: "We have to think about where we are we in the journey and monitor progress over time of the investee companies, with focus on areas of materiality, the most impactful areas."

Sivyer said that some managers sounded a cynical note that supplying information for GRESB feels like "just a data-gathering exercise." Redington, however, sees other managers take a more pro-active approach. "Data informs action," he said. Redington appreciated managers using data-gathering as touchpoints with tenants, collaborating on means to improve energy efficiency such as metering.

Welter agreed that the level of emissions disclosures is terribly low and estimates from third-party providers don't improve matters much. "But even if all companies reported Scopes 1-3, that would not be enough," he argued. "Because it doesn't tell you where they will be in 10-15 years' time."

VLK's remedy has been to build its own Emissions Transition Pathway in order to model long-term goals and targets for not just property companies but also individual buildings.

Acheson chipped in that with Private Markets' investments, you are locking up capital for 10 years, so your analysis must be forward-looking. She said that expectations must be managed upfront: "It depends on what clients are willing to achieve. The number of buildings that are 100% green to-date is very small. To make best-in-standard buildings for core purchases needs capex."

She said that organisations mindful of Environmental, Social and Governance criteria have the mandate to show they can transition assets where needed.

"It is a journey we are all on," said Acheson. It might take ten years to make that impact." But she warned that managers who do not incorporate ESG into their outlook are missing out on winning mandates.

"It's not just about the greenest," she said, "but also transition. Some assets initially look terrible. It takes a lot of picking apart and evaluating the positives and the negatives. In the last five years, managers have needed to align or not get their hands on the capital."

Jeffs said that the valuation upside is coming. He reckoned that since energy bills went up, everyone is taking a much closer look at Energy Performance Certificates. M&G is building net-zero homes and he argued that prospective buyers will apply a premium. "In time, the value of energy savings will become apparent."

He noted that the British Property Forum was lobbying the UK government to advance ESG regulation in homebuilding.

On direction from governments, Welter said that Europe was ahead of the US and Asia when it came to environmental legislation. Because of that, top-tier data centre companies such as Equinix with a sizeable European footprint were committing to EU climate regulations.

Welter argued that investment management comes back to governance. "We need long-term planning by company management."

Rodriguez agreed that the US definitely doesn't put two feet forward when it comes to environmental legislation unlike Europe where environmental policy leads.

"With our sustainability process, ACI tries to identify long term risks and benefits from a sustainability perspective to each company's business model." But he added that "long term" is not the only focus required. "From a business-model perspective, there needs to be near-term incentives for returns on investment (ROI) too."

He saw this push and pull being led by larger

business platforms today and deeper institutional property ownership. "It starts with management having a conversation with debt and equity holders about what they want; how material sustainability is to their business model."

When it comes to the properties themselves, Welter noted that there are consultancies helping to reckon these figures. He mentioned one based in Copenhagen that figures when existing buildings can be renovated while retaining the skeleton structure. This is where engineering combines with ESG considerations to determine the best course of action.

"At VLK, we focus in on property data on the environmental side, building by building," said Welter. "The knowledge is there as to when each building was last renovated. This informs capex needs and feeds into our investment process."

He gave the example of Euston Tower in central London, owned by British Land. VLK's information allows it to assess what British Land is likely to do with this landmark property and thus whether to invest in the company.

Jeffs agreed that measurement becomes complicated when you attempt whole-of-portfolio calculations, including embodied emissions from the manufacture of building materials.

Arup, the engineering consultancy, makes inputs into M&G Real Estate's sustainable framework. Jeffs noted that for residential property funds, such as M&G Affordable Housing, there are already sufficient data – ultimately from tenants and operational expenditure - to compare ESG criteria against peer funds.

"The difficulty with this sector is getting access to tenants' energy usage," he explained. There are barriers in the form of tenants' right to confidentiality and privacy. On the other hand, Jeffs said that remote modelling and better collaboration with residents were already helping to inform capex spending and efficiency.

> *Managers who do not incorporate ESG into their outlook are missing out on winning mandates. It's not just about the greenest, but also transition. Some assets initially look terrible. It takes a lot of picking apart and evaluating the positives and the negatives. In the last five years, managers have needed to align or not get their hands on the capital."*

Roundtable Participants

Steve Rodriguez
Vice President Portfolio Manager

Personal Profile

Steven Rodriguez is a vice president and portfolio manager for American Century Investments. He is based in the company's New York office.

Steve co-manages and provides fundamental research and analysis for the firm's five real estate securities strategies.

He joined American Century Investments in 2009 from Barclays Capital (formerly Lehman Brothers) where he was a REIT equity research associate, responsible for conducting fundamental research and analysis on REIT securities, as well as analyzing real estate industry trends. Previously, Steve was an associate with PricewaterhouseCoopers, LLP.

Steve holds a bachelor's degree in economics and a master's degree in accounting from the University of Michigan.

Company Profile

American Century Investments is a leading global asset manager focused on delivering investment results and building long-term client relationships.

Founded in 1958, the firm serves financial professionals, institutions, companies and individual investors. Over 40% of the firm's dividends are distributed to the Stowers Institute for Medical Research, a non-profit basic biomedical research organization. The Institute owns more than 40% of American Century Investments and has received $1.87 billion in dividend payments since 2000.

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Chris Jeffs
Fund Manager – Affordable Housing

Personal Profile

Chris is the Fund Manager for the M&G Shared Ownership Fund. Over his career he has transacted over £1 billion of real estate which includes forward-funding and forward-purchase agreements, comprising over 50 deals across commercial, residential and alternative sectors. Chris has also been involved with a number of development projects with a total GDV of c.£250m.

Prior to his role as fund manager, he worked as Head of Industrial and Logistics team, responsible for the strategic management of over £3 billion of assets across the UK. Before that, he was an investment manager in the retail team, responsible for the strategic management of c.£1.6 billion of retail and leisure assets.

Prior to joining M&G Real Estate in 2014, Chris worked in BNP Paribas Real Estate's Recovery and Restructuring department leading the asset management and disposal of distressed residential portfolios with a value of c.£200m on behalf of banking clients.

Chris has an MSc in Property Development from the University of New South Wales, Sydney, is a member of RICS, the IPF, a member of the British Property Federation Affordable Housing Committee and is a qualified Law of Property Act (LPA) Receiver.

Company Profile

M&G Investments is a global asset manager with a long history investing and innovating across both public and private markets. We're part of M&G plc, an international savings and investment business with the ambition to deliver long term value for our investors, while working together to create a more positive future.

As an active manager we build solutions around what matters most to our clients whether it be investing for growth or income, to meet future liabilities, protect capital or invest responsibly. Together, through a strong sense of partnership and collaboration, we support a culture of continued innovation to build long-term relationships as needs evolve over time.

We offer access to a broad range of capabilities that span both public and private assets including fixed income, equities, multi-asset, real estate, infrastructure and private equity.

Globally we manage over £303.2 billion (as at 30 June 2023) on behalf of individual and institutional investors including pension funds, endowments and foundations, insurers, sovereign wealth funds, banks and family offices.

M&G Investments

Roundtable Participants

Andreas Welter

Senior Portfolio Manager Global Real Estate

Personal Profile

Andreas joined Van Lanschot Kempen in November 2021 as a Director/Senior Portfolio Manager focusing on the Listed Real Estate strategies.

Andreas has more than a decade of real estate investment management expertise having previously worked at the American real estate specialist Heitman in London, most recently as a Co-Lead Portfolio Manager of European real asset equities.

Before Heitman, he was a sell side analyst for Deutsche Bank in Frankfurt covering companies in the financial, real estate, transportation and industrials sectors. Andreas is a qualified banker (Bankkaufmann), received the CFA Certificate in ESG Investing and holds a MBA in International Business Administration (Diplom-Betriebswirt) from Darmstadt University of Applied Sciences.

Andreas (43) is German by origin, married with three children and has made London his home since 2010.

Company Profile

We are active managers who bring free thinking, resolve and originality to investment decisions. This helps us to reach hard-to-access asset classes that are often missed by our competitors.

As leading fiduciary managers, we look after large pension portfolios for our Netherlands and UK clients – taking great care to facilitate good outcomes for everyone invested in our schemes. What's more, all clients benefit from our fiduciary expertise and investment infrastructure.

VAN LANSCHOT KEMPEN

Sarah Acheson

Investment Director, Private Client Practice

Personal Profile

Sarah is an Investment Director in the Private Client Practice within Cambridge Associates' London office. Sarah works with private clients globally in building and managing their private investment portfolios.

Sarah has also been a member of the Real Assets Investment Group, covering strategies and services across real estate, infrastructure and natural resources with a focus on the EMEA region. The team works to identify high conviction managers for clients across the full risk spectrum of investments.

Prior to joining Cambridge Associates in 2018, Sarah worked for TH Real Estate (previously Henderson Global Investors) where she spent approximately 6.5 years in the investment team. During the start of her tenure she was a part of the European Indirect Team, responsible for fund investing in Europe for one pooled fund vehicle and three segregated accounts. At the time of her departure, Sarah held the position of Associate Investment Manager and was responsible for the portfolio management of a €1.3 billion retail focused joint venture. Prior to her previous role which she started in 2011, Sarah graduated from the University of Nottingham with a degree in Economics during the same year.

EDUCATION: Investment Management Certificate (IMC), CFA, Society UKSc Economics, University of Nottingham.

C|A CAMBRIDGE ASSOCIATES

David Whitehead

Equity Portfolio Manager

Personal Profile

David Whitehead is an Equity Portfolio Manager at Mediolanum International Funds Ltd (MIFL). Based in Dublin, he is responsible for the firm's suite of sector specific funds, alongside European and European Small Cap strategies.

He also manages Energy Transition and Circular Economy funds, which sit within the firm's thematic and ESG-focused strategies.

Prior to joining MIFL in 2020, David was an Investment Analyst with DFP Pension & Investment Consultants and Beacon Trust Fund Management, responsible for portfolio construction. His previous roles include being Assistant Vice President at Citigroup and an Analyst with BNY Mellon.

David has a degree in Accounting and Human Resource Management from National College of Ireland, and a Master's in Strategic Management from UCD Smurfit Business School. He has also earned the Accounting Technician's qualification with Accounting Technician's Ireland.

mediolanum INTERNATIONAL FUNDS

Roundtable Participants

James Sivyer

Vice President,
Private Markets team

Personal Profile

James is a Vice President in the Private Markets team at Redington focused on real estate fund research.

Before Redington, James worked in the investment team at Addlewood Investment Advisors, analysing real estate deals. James is a CFA Charterholder and holds a BA in Japanese from the School of Oriental and African Studies.

Beatrice Atena Stanoescu

Investment Consultant

Personal Profile

I am a Consultant within the XPS Investments team and based in London.

I work on a range of clients of different sizes across the UK. I am also a member of the Charities and Endowments team and lead our Alternative Investments research team.

I possess investment expertise, across private markets in particular, from my previous role managing fixed income portfolios for a diverse clientele via designated mandates as well as bespoke solutions.

Prior to XPS, I was involved in underwriting high yield bonds for private companies sponsored by Private Equity firms. I am a member of 100 Women in Finance. I have a First-Class BSc degree in Business Studies with Marketing from Canterbury Christ Church University and a Masters degree in International Management and Finance from King's College London.

Moderator

Brendan Maton

Freelance Journalist

Personal Profile

A highly experienced financial journalist with an expansive network of contacts in the UK and across Europe. Brendan has written about pension schemes and national welfare systems from Finland to Greece for 18 years and understands the retirement savings industry in each European country.

Brendan has interviewed EU commissioners and national ministers; central bankers; pension scheme heads; insurance chief executives; chief investment officers; actuaries; union officials; professional and lay trustees.He worked at Financial Times Business for eight years, finally as editor-in-chief of all international pensions titles.

Brendan has spent the last ten years as a freelancer for a number of publications, including Financial Times, Responsible Investor, Nordic region pensions news and IPE. He is also Chief webcast host for IPE.

Brendan has acted as conference chair for Financial News, the UK National Association of Pension Funds, Dutch Investment Professionals Association (VBA), Corestone, Insight Investment, Marcus Evans, Robeco Asset Management, Sustainable Asset Management (SAM), Towers Watson.

After a Selloff, Public REITs Set to Perform

“Public REITs trade at the most attractive valuations we have seen since the Great Financial Crisis”

Authors:

Steven Brown
Senior Vice President
Senior Portfolio Manager

Steven Rodriguez
Vice President Portfolio Manager

Vishal Govil, CFA
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Senior Investment Analyst

Brandon McKinzie
Client Portfolio Manager

Key Takeaways

- A bruising selloff in 2022 cast a pall over public REITs but they now trade at attractive valuations.
- History shows us that public REITs have outperformed in the aftermath of monetary tightening.
- Supply and demand imbalances serve as a tailwind for REITs, particularly for data centers and select residential real estate markets such as single-family rentals.

A Tough 2022

When the markets closed on Dec. 31, 2021 — a few hours before corks would fly from champagne bottles to usher in the new year — shares of IYR, a public real estate investment trust index, traded at $116. That share price represented the index’s peak over five years, seemingly presaging a strong 2022 for public REITs.

That did not end up happening. Instead, the Federal Reserve and other central banks spent the year increasing interest rates dramatically — poison for real estate investors when done so quickly— to beat rising inflation. Public REITs tumbled the rest of the year.

It appeared that 2023 would shape up as more of the same. Interest rates kept going up. Inflation stuck around. Big office defaults happened. Major regional banks failed. Lending standards tightened.

But a peek behind headlines about the travails of commercial real estate might help investors come to understand why we remain optimistic for listed REITs for the rest of 2023 and 2024.

They may also notice how one of the most puzzling riddles in the real estate investment scene — the disconnect in values for private real estate versus listed REITs — bolsters our confidence in publicly traded REITs.

The Interest Rate Cycle

Fed chair Jerome Powell and the Federal Open Markets Committee (FOMC) members have been careful not to tip their hands in public statements and press interviews about what they may do on interest rates, insisting that data will drive their decision.

The FOMC announced on Sept. 20 that it would hold rates steady at 5.25-5.5%. Looking further out, Fed Fund Futures are not projecting any further hikes for the balance of 2023 with the next possible cut happening in late-2024.

We tend to agree that the Fed is at or near the end of its tightening cycle. True, inflation remains higher than the Fed’s 2% target, but it has cooled down faster than many expected it would by this time of the year. We also don’t think the Fed will jump into a rate-cutting cycle any time soon, absent some unforeseen financial calamity that would require such an approach.

While higher interest rates generally don’t benefit real estate, 30 years of market research reveals something interesting: Whenever rates stop increasing, REITs spent the next 12 months outperforming broad equities. Our research shows the average return for REITs during these 12-month periods more than doubled that of the S&P 500 over the last three decades.

REIT Performance During and After Rising Yields

Dates		Yield			REIT Returns		S&P 500	
Start	End	Starting Yield	Ending Yield	Change in Yield (bps)	Rising Rate Period	Following 12 Months	Rising Rate Period	Following 12 Months
11/1/1993	10/31/1994	5.56	7.81	225	-5.98	12.22	3.87	14.71
2/1/1996	5/31/1996	5.63	6.85	122	3.74	29.31	6.07	29.41
10/1/1998	1/31/2000	4.33	6.68	235	-5.37	27.26	28.32	-0.90
11/1/2001	2/28/2002	4.24	4.88	64	10.37	0.34	4.96	-22.68
7/1/2003	7/31/2003	3.56	4.49	93	5.35	21.00	1.76	13.17
4/1/2004	4/30/2004	3.91	4.53	62	-14.58	34.62	-1.57	6.34
6/1/2005	6/30/2006	3.91	5.14	123	22.91	12.57	8.08	20.59
1/1/2009	5/31/2009	2.06	3.46	140	-8.81	55.98	2.96	20.99
10/1/2010	1/31/2011	2.52	3.38	85	11.86	10.61	13.38	4.22
5/1/2013	12/31/2013	1.63	2.97	134	-10.52	28.03	17.43	13.69
1/30/2015	6/30/2015	1.65	2.36	71	-5.44	23.62	1.23	3.99
7/1/2016	10/31/2018	1.47	3.15	168	1.39	25.32	13.84	14.33
8/1/2020	12/31/2022	0.54	3.88	334	4.70	-	8.51	-

Notes

Average return after rising rates:

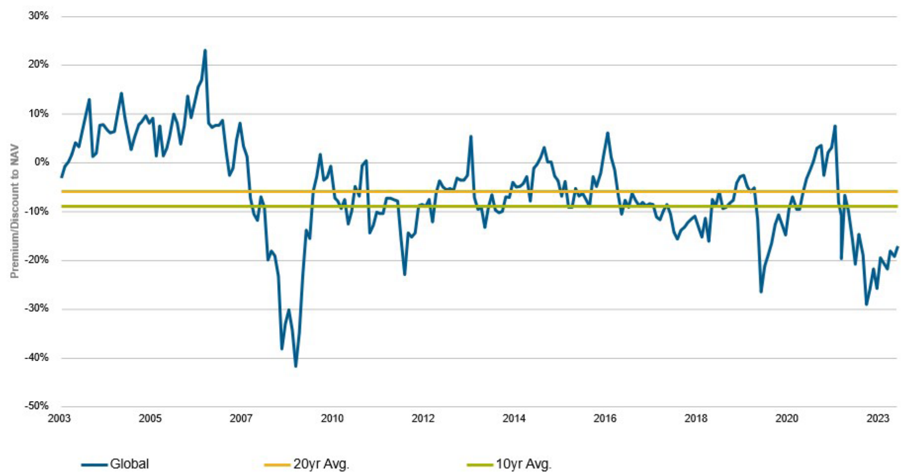
REITs: 21.1%

S&P 500: 10.4%

Data as of 12/31/2022. Source: FactSet. REIT Returns are FTSE-NAREIT All Equity REIT index total returns. Yield refers to 10-year U.S. Treasury Yield. Past performance is no guarantee of future results.

We think this history may repeat itself. For one thing, listed REITs have largely priced in lower asset values and potentially a recession that may or may not happen. Earlier in the year, a recession seemed likely. Now, thanks to a still-strong labor market and consumer resilience, economists are second-guessing that assumption. And while we think REITs, which trade on exchanges daily, have priced in the recession, private real estate has been slow to meaningfully mark down its assets. As private real estate values are reset appropriately, publicly listed real estate companies with materially better balance sheets should be able to take advantage of strong investment opportunities as we have seen in prior cycles. Either way, REITs currently trade at attractive valuations, meaning now might be a good time to consider them.

Global Real Estate – Premium/Discount to NAV



Data from 6/30/2003-6/30/2023. Source: UBS. Data based on UBS Global Real Estate Universe.

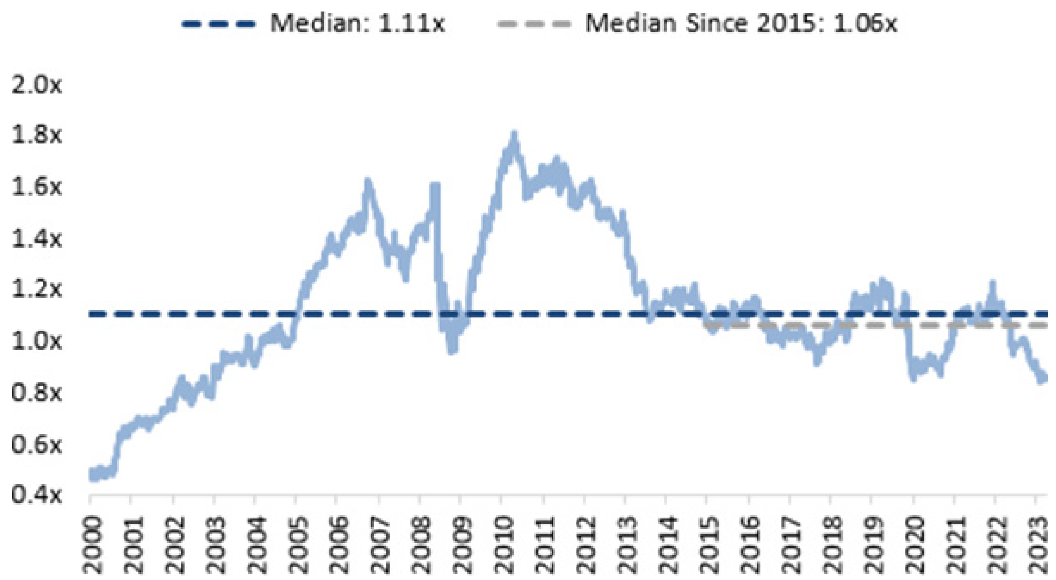
Valuations and Fundamentals

Valuations are the second reason we are keen on listed REITs. Public REITs trade at the most attractive valuations we have seen since the Great Financial Crisis. And, unlike the financial crisis, the underlying fundamentals of real estate are generally much stronger.

Take data centers, for example. Supply chain issues, lack of power availability and cost inflation caused by the pandemic meant that fewer new data centers came online. Vacancy rates for existing data centers dropped as a result. Now data centers enjoy strong pricing power, due not only to the limited supply of space but also the significant demand coming from the excitement over artificial intelligence. Select residential real estate fundamentals also remain strong from an investment perspective.

Residential Real Estate

Within residential real estate, we favor single-family rental REITs in the United States for several reasons. Rising mortgage rates have forced many U.S. households into renting, given low purchase affordability today as well as the costs of renting a home compared to buying reaching its widest gap in several decades. For example, as interest rates have gone up, the average monthly mortgage rates for prospective homebuyers has increased 70%, according to data from the National Association of Realtors.
Single-family rental assets — think suburban stick-built homes across the U.S. — provide growing households a value alternative with more living space at much more affordable cost than many urban and suburban multi-family communities with much smaller units. Lastly, supply is much more muted relative to demand in the single-family market relative to demand resulting in strong pricing power for single-family rental landlords.



Data as of 6/30/2023. Source: FactSet.

The Credit Cycle

Every few months, the Fed asks loan officers at some 80 large U.S. banks about changes in their lending standards. The Senior Loan Officer Opinion Survey (SLOOS) over the last year has shown less enthusiasm by banks to loan to commercial real estate as concerns about the long-term health of the economy came into question. The July SLOOS report indicated that banks tightened their lending standards on all categories of commercial real estate loans for the last four quarters.
That's generally bad news for developers, who either can't get a loan or, confronted with having to pay more to borrow, decide to stop building. But for REITs, tighter lending can be a good thing as it causes a mismatch of supply and demand. New commercial real estate development starts have fallen dramatically and now sit below long-term averages as a percentage of total stock. We expect this to fall further as bank lending remains tight for commercial real estate. The consequence, leaving all else equal, will be better pricing power for current landlords.

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UK long lease real estate: A unique access point for new capital

> *"With improved value and current access to ready-made, high quality portfolios, we see a unique opportunity to enter the market."*

Investment market conditions for UK long lease real estate look more attractive than they have since the GFC. With the retreat of Defined Benefit (DB) pension schemes as well as a rapid repricing of UK real estate in response to interest rate rises, an opportunity has arisen for new sources of capital to access investment grade, inflation-linked cash flows secured against high quality real estate, at what could be attractive value.

In the past, investing in UK long lease property has largely been the preserve of DB pension schemes. The asset class was effectively built for such investors owing to long leases and contracted income, linked to inflation; helping pension schemes to hedge long-term liabilities and meet their cashflow requirements.

As a hybrid between fixed income and real estate investment, the asset class offers the benefit of quarterly rental payments, akin to a coupon on a bond. Backed by prime UK real estate through structures such as sale and leasebacks, income strips and ground rent transactions, high quality portfolios might include business-critical property or key operating assets for investment grade tenants such as listed companies, universities or local authorities.

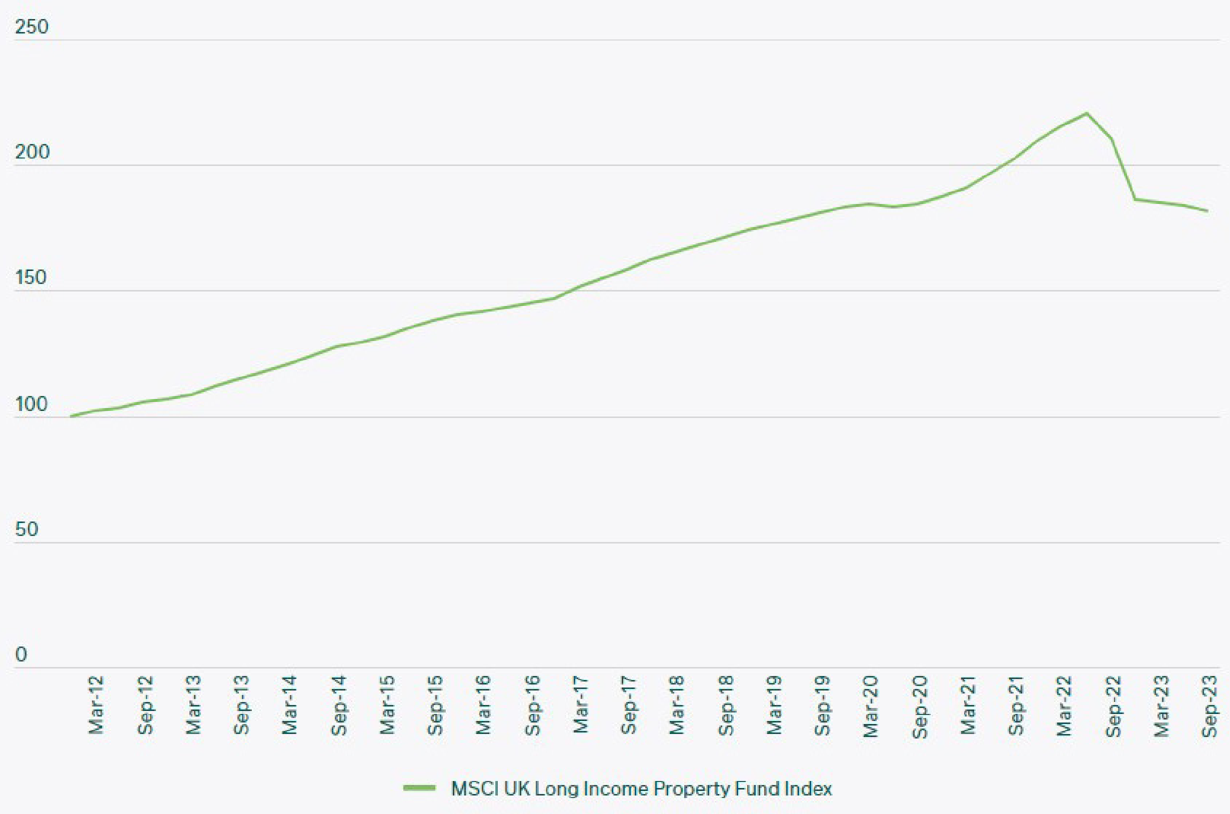
However, some traditional long income investors are now retreating, as DB schemes de-risk overall portfolios to prepare for buy-out, meaning what has until recently been an oversubscribed asset class is now accessible to new sources of capital. The return profile is well aligned to the objectives of many investors; whether seeking yield, inflation protection or liability matching, as well as the opportunity for capital value growth from the underlying property.

An attractive entry point?

While strong and sustained demand from DBs for over more than a decade fuelled tight pricing for assets, entering the market today could offer good fundamental value given the asset class has repriced significantly.

"The risk/reward equation from investing in long income has never looked so good," says Lee McDowell, Fund Manager. "We're back to post-GFC pricing but the market was embryonic then; it's now a mainstream asset class."

Long lease property can offer stable, long-term performance with attractive return potential



Source: MSCI UK Long Income Property Index, as at 30 September 2023.

The speed of correction underscores the potential buying opportunity. Now there looks to be more certainty around interest rates in the UK, real estate revaluations have played out with more haste – certainly faster than during the last crisis. During the GFC, repricing was debt-driven due to a credit squeeze, with falling interest rates helping to cushion the fall in values. This time around, the opposite is true; interest rates started from a low base and have corrected sharply to counter inflation. Whilst it is true gearing levels are lower, valuations have had to adjust rapidly in response.

M&G Investments

Potential valuation gain

As values find a floor, investors could target a cyclical opportunity to capture a potential valuation gain. The UK real estate market has repriced faster and further than other markets, with long lease real estate at the forefront owing to its bond-like qualities. The asset class could therefore be closer to reaching a stability in values, providing more certainty over asset pricing. Contracted rental growth also creates more liquidity than in other parts of the private market, given confidence in future cash flows. This makes it easier to ascribe a value even amid economic and rates uncertainty, helping to inform investment decisions.

“With improved value and current access to ready-made, high quality portfolios, we see a unique opportunity to enter the market,” says McDowell. “If we are at the start of a new real estate cycle, in our view this is an attractive place to invest. Long lease real estate offers a defensive, low risk real estate investment with the potential for secured cash flows, with growth over time.”

A well-timed value opportunity for a range of investors

McDowell describes a ‘back to basics’ investment proposition for UK long lease real estate in today’s landscape. “Investors can now buy into high quality assets and defensive real estate sectors and be rewarded for owning prime real estate. Less than five years ago, you had to go up the risk curve to find additional yield”.

Increasingly, investment opportunities are likely to arise as a result of less liquidity in the traditional bank and bond markets. This is driving companies such as high grade corporates and public bodies to seek non-bank and non-public forms of lending, creating demand for long-dated funding structures such as income strips, which can provide a competitive source of financing for over 30 years or more.

We believe the ability to access ready-made, high quality long lease real estate portfolios with attractive cash flows could reflect a well-timed value opportunity for a range of investors. Both real estate and credit expertise will be valuable in creating innovative and resilient investments across different property types and funding structures, with the potential to deliver consistent and attractive risk-adjusted returns.

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VAN LANSCHOT KEMPEN

A Green Revolution along the motorway

Electric trucks that can charge their batteries with locally-generated solar energy next to the warehouses where they load their cargo. Greenwarehouses and a circular logistics chain: is this a utopian dream, or (almost) reality? As yet, logistics real estate has a boring, unsustainable image: vast, blocky boxes along motorways with trucks driving in and out. However, even inthis sector too, there are exciting developments that can contribute to the energy transition in a meaningful way. Belgian logistics real estate specialist WDP - one of the portfolio companies of the Kempen Global Real Estate strategy - decided about two years ago to significantly accelerate its sustainable ambitions. This autumn, the company set a record by constructing the largest interconnected solar roof in Europe at one of its warehouse. And WDP certainly isn't finished yet.

> *“Logistics buildings can play a major role in making transport companies more sustainable.”*

A more sustainable supply chain

Logistics real estate often means owning and maintaining logistics infrastructure; often, this consists of operating large warehouses that themselves consume relatively little energy. It is therefore quite feasible for a logistics property company to reduce its own CO_2 emissions (the so-called ‘Scope I’ emissions) and its emissions from purchased energy (‘Scope II’). That said, to actually achieve this, the ambition needs to be there, of course. For instance, WDP aims to bring emissions from all its own offices to net zero by 2025 and to fully-electrify its own vehicle fleet by 2030.

A more substantial challenge lies in the so-called ‘Scope III’ emissions: emissions from supply chains. For WDP, this mostly consists of maintenance and renovations of their warehouses by third parties, as well as customer energy consumption in warehouses. These customers are also encouraged to lower their emissions from the transportation of their goods: i.e. the emissions of the trucks that pick-up and deliver cargo to the warehouses. WDP is eager to assist clients in achieving this on a larger scale.

Electric vistas and energy factories

Egbert Jan Nijmeijer
Co-head Real Estate

How to approach this? The answer has become obvious over the last couple of years: electric trucks are the way forward over relatively small distances in the transport sector. Today, e-trucks make up a very small portion of total haulage. Just 42 electric lorries were registered in the Netherlands in 2021, ccording to available data. Across Europe, there were just 346 e-trucks on the road that year: a very tiny figure, but almost triple the figure from 20201.

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Early in 2022, Volvo, which positions itself as the industry leader in this category, announced that it had received orders for 1,100 new electric trucks from 20 countries2.

This is a trend that may accelerate quickly, particularly given the increasing cost of petroleum. According to Volvo, 50% of all newly-delivered trucks will be electrified by 2030. Moreover, the number of smaller electric vans on European roads has already increased significantly.

Therefore, it makes sense that WDP is preparing for this trend with a project that appears to be both straightforward and revolutionary at the same time: the company is mounting sustainable energy facilities on the rooftops of its warehouses not just to power the warehouses, but also for charging stations for electric vehicals. Surplus electricity is either sent to the public grid or stored in batteries. In the future, a portion of the energy produced may potentially be sold directly to other parties.

Warehouses thus will gain a second purpose: that of small, local energy plants. These will offer customers an all-in-one solution: lorries will be able to charge their batteries while loading products; a stop at another charging station will no longer be necessary.

When is this plan really going to take off? WDP already has a trial programme running in Zelik, Belgium, and is investing in growing these so-called ‘Green Mobility hubs’ in the near future. For a large-scale roll out, a further liberalisation of the European energy market is required

A greener view?

WDP has already set records with its sustainability strategy: at its warehouse in Evergem, close to Ghent, WDP boasts a massive, interconnected solar roof – Europe’s largest. There, 37,000 solar panels cover an area of 150,000 square meters of roof (the size of roughly 20 football pitches). This generates around 21,000 MWh of energy annually, which is sufficient for about 8,000 households. The warehouse uses a portion of this solar energy, with the remainder being supplied back into the public grid. Setting up direct supply agreements with surrounding firms is next on WDP’s agenda.

The company has also started construction of a new warehouse near Breda with a strong focus on biodiversity. Green facades and roofs will be constructed and the design (with rounded corners, a lowered façade, and earthy tones) also counteracts the monotonous, generic warehouse views along the motorway. A win for the climate and a win for the views of the surrounding landscape in one fell swoop.

Positive energy

The sustainable steps WDP is taking make the Belgian family-owned company a leader in the energy transition, argues Egbert Nijmeijer, Van Lanschot Kempen’s co-head Real Assets. While most focus has been on aiming for net zero greenhouse gas emissions (i.e. balancing carbon emissions and reabsorption equally), logistics property lends itself to becoming net energy positive. ‘That’s what WDP wants to achieve,’ says Nijmeijer. ‘In combination withbattery storage, the logistics buildings can play a major role in making transport companies more sustainable, without unduly straining the energy network with massive energy feedbacks. This way, energy is produced locally and consumed locally. Such initiatives really do make a difference to the planet.’

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