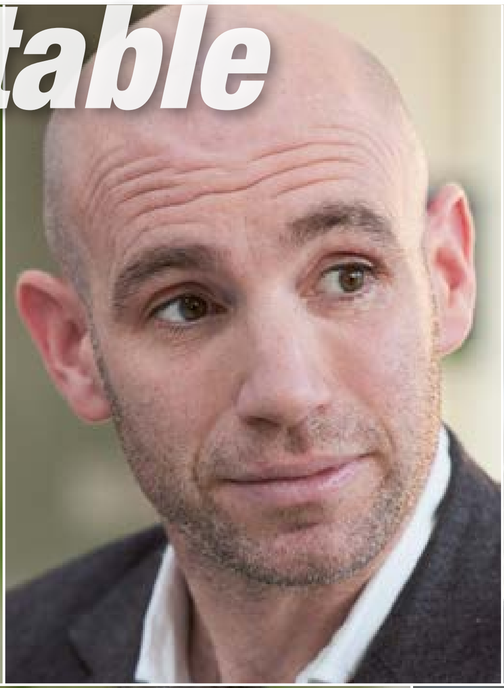
pi REAL ESTATE

roundtable



EDMOND DE ROTHSCHILD

PICTET 1805 Asset Management

Adrian D'Enrico | Charles Baigler | Louise Warden
Nick Spencer | Ben Ward | Tom Sumpster

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DISCUSSION: REAL ESTATE

We live in them. We work in them. We buy our groceries from them. We make things in them, store things in them and we unwind, relax and are entertained in them: property is a diverse market, serving many of our needs. But as times change, markets change and property is no exception. Residential has become an institutional asset class as demand for housing grows due to shortages and changing lifestyles. Then there is retail, where, if you walk down many high streets, demand for space from household names is not as strong as for out of town warehousing, thanks to the growth in online shopping. Another issue is the growing demand for assets that are kind to the environment and society. ESG is not just about equities. To find out how this asset class is evolving, we sat down with a panel of experts to discuss how pension schemes and insurers are investing in property.

What real estate strategies are institutional investors following?

Louise Warden: LPPI's focus is predominantly core, with an element of value-add and opportunistic. A large proportion of our assets are in the UK, where we invest directly and via funds.

Ben Ward: Property sits within a few of our underlying asset classes. We have property equities, fixed income and private equity as well as a direct book, which is a growth strategy carrying more risk.

However, our largest exposure to property is in the secure income space. That is mostly UK long-lease and ground rents, which are a bond proxy with an illiquidity and complexity premium.

What interests Phoenix about real estate?

Tom Sumpster: The macro environment we are going into is dislocated compared to the last 10 years. That provides investment opportunity, typically in public markets where valuations have corrected.

In private markets, debt is far more appealing than equities. The relative value is tight and we are looking for corrections coming through.

We are risk-off in private markets, and risk-on in public markets. When we think about debt, we are looking to invest longer term into core real estate. So, we see parts of the market as a safe haven.

Charles, where are institutional property investors looking for growth?

Charles Baigler: Our funds have a pan-European outlook. For our value fund, we look for price dislocation. Where there is distress and forced sellers, the UK is probably ahead of Europe and offers a lot of opportunity.

We also see northern Europe as a more attractive proposition than southern Europe. Northern Europe overshot in terms of yield compression, so that is adjusting faster.

The availability of debt is also higher. Pressure from sellers who are over-levered tends to be a northern European phenomenon, which is a different proposition from the last cycle.

Has the macro picture impacted affordable housing?

Adrian D'Enrico: Thankfully not. It is almost the thesis for investing in affordable housing.

We don't have enough houses in this country. There are 1.2 million households on the waiting list and 123,000 children will not sleep in a permanent bed tonight. Demographic drivers and the economic situation will make it worse before it gets

better, so the thesis has not changed.

It does, however, make it slightly difficult in terms of financing. Leverage is not accretive to what we are trying to achieve, but equity investment is coming – we recently secured an investment from a local government pension scheme.

Investors are attracted to the long-dated, inflation-linked income while delivering an impact. We are an SFDR Article 9 fund. Affordable housing is seeing some appetite for people ticking a box in some instances, but there are parties who want to deliver a genuine, long-term impact and we can deliver that for them.

How has what institutional investors want from property changed in the past 10 years?

Nick Spencer: Ten years ago, we were coming out of the financial crisis and pension schemes started looking at private debt. I have always felt quite enthusiastic about private real estate debt because of the secure assets that sit behind it.

Defined contribution (DC) has also emerged. That has provided more renaissance in terms of listed equity, so more interest in real estate investment trusts (Reits).

Some development in DC strategies is needed because when you reach retirement there are still 20 to 30 years to fund. Having a real income that is secured long-term is a natural asset class for DC investors, especially post-retirement. I expect more developments there.

Those are the two trends if we go back 10 years. More recently, the focus has looked at place-based investing, such as social housing and the 'S' element of ESG. The new kid on the block is probably broader about the interaction with the environment, such as water usage.

In the current environment, are investors waiting to see what happens or, like Phoenix, planning to take advantage of the uncertainty?

Ward: I'm with Tom. Public markets are massively dislocated. Yields to maturity on high-quality bonds are quite staggering relative to property yields.

Sometimes you see negative gearing too. Taking less income yield than an ungeared property when refinancing is a phenomenon for some people, but it may be the only way they can keep that property.

Short term, it is all about public markets for us; in prior cycles that relative value always normalised, then property provided the private market premium. We will be back when it looks like better value.

The potential for real estate to outperform inflation means it plays a valuable role.

Nick Spencer
Sustainable investment adviser
Gordian Advice

Warden: We see opportunity in direct UK real estate this year. There was significant repricing in Q4, quite short and sharp. Those re-based valuations are an attractive entry point for equity investors like us.

Then there are assets that might come to market as people cannot refinance. We are well placed for that.

What has had a bigger impact on valuations: rising interest rates or working from home?

Sumpster: Interest rates play into a short-to-medium term situation. The question therefore is: will interest rates go back to the low yields that we have seen? Most commentators will say "unlikely" given that it was a 10-year period which probably will not be repeated. So, what will be the correction to equity values and how do we think about that? That is a big distinction.

Working from home is a fundamental change in the way people live, work and play. When we look at offices, less desk space is likely to be required in the future or perhaps it could be broader as employers try to encourage individuals to come into work.

Spencer: Part of that story is also going to be differentiation between properties. Prime will retain its cache, but if office or retail usage falls then it is the values of non-prime assets that are likely to drop away. But lower values should then catalyse change and re-usage.

One of the next changes is what to do with empty retail properties in town centres. There is an interesting set of opportunities for place-based investment to reinvigorate those.

D'Enrico: We have started to see that already with medical uses on the ground floor of retail frontages with the uppers converted into residential. It is about making it useful long term.

If we are focused just on the 1% of every market we are building new each year, we will not touch much of what needs to be around in 2050 to hit net zero. But we could achieve this as part of a change of use-led refurbishment of existing stock.

Baigler: The challenge is that you need a significant value alteration for that to make sense. The direction of travel is clear: we are going to see a huge obsolescence of secondary and tertiary real estate. So, how are we going to repurpose that?

Shopping centres are a prime example. They occupy the best locations in small towns and most people are realising that the best value is the land. The poorly configured building as an economic proposition does not make sense for most investors.

That is the big challenge: are the owners prepared to accept that the obsolescence of those buildings is so high that their residual value is possibly much lower than they believe? We have an industry where valuations are driven historically, and by the owners, so there is going to have to be some give there.

Does high inflation and rising interest rates mean investors could move away from traditional property assets?

Baigler: It depends on your cost of capital. As a value-add investor, change of use is where we want to deploy our capital. For longer-term investors, it is a far greater challenge.

Sumpster: From our perspective, ground rents are hugely appealing for long-term patient pension capital. It is where we want to play with our defined benefit schemes. But when we think about the future and how we can create a better yield pickup for defined contribution pension liabilities, it is looking at regeneration, the levelling up agenda and connecting a storyboard together.

This is a real assets play where we talk to the metro mayors and the combined authorities. We look at a landmass and try to understand what they want to do with it.

Decarbonising that land through the development is part of that. Older stock that is energy inefficient becomes redundant more quickly making refurbishments imperative, which is another investment opportunity.

How do valuations differ in private and public markets and what does it tell us about where we are going?

Spencer: We see this dislocation in Reits and other listed securities as well as in the better bets on the private debt side. The question is how will that play out and how quickly.

People say that by Q3 it may work out. In the meantime, private investors should be patient with their capital and look for idiosyncratic opportunities. We will get some distressed sellers and some dislocations. Rarely seen assets will probably come on to the market – ones that you want as long-term keepers. Those are the opportunities to look for as those valuations reset.

Warden: The greatest impact to date has been on our UK portfolio. There is something to be said about it repricing faster than some other regions. That is why UK real estate might provide attractive opportunities.

What returns are investors expecting from property?

Baigler: Our target returns have not changed, but how we access them will. Two years ago, we were looking to generate returns using cheap leverage and reasonable rental growth forecasts to create alpha through change of use and development. That is starting to change depending on which country we are in.

Those returns may now be achieved from less risky assets at a time when there are strong rental growth forecasts in lots of markets. Again, that is only if you are creating the right products.

The most important thing we are going to see across all countries and sectors is a clear bifurcation. There are going to be assets which institutions and occupiers want, and assets which appear cheap but you will be catching a falling knife if you buy them. They are secondary assets, which you are going to either reposition or, in the worst case scenario, knock down.

This is almost exclusively ESG driven. If you are on the wrong side of this, it is going to be impossible to finance or occupy as new regulation comes in.

D'Enrico: We have not changed our expectations. We still target the same long-term inflation-linked income distribution of about 4%, with a total return of 6% to 7%. We cannot use leverage to enhance that, so returns reflect the individual tenure pricing, ranging from social and affordable at 3% to 4% all the way through to yields on extra care and homeless accommodation at 6% or greater. Pricing has remained remarkably stable, which is part of the attraction of the sector – long-term, dependable income which is inflation linked.

Ward: Returns are likely linked to inflation. How long are rates going up, and how much higher? Last time I looked at 10-year gilts forwards, there was an upwards curve arguably implying that with a fair value margin for property, things are going to get worse.

Once we hit fair value, it will restart the competition for the best quality assets. Before that though anyone sat on property portfolios should expect a bit more value movement downwards – whilst income generates positive total returns.

It is hard to call but some people will get the occasional bargain, whilst most sit on existing portfolios with weak returns in the short-to-medium term.

Warden: We are measured over a 10-year period, so we are somewhat insulated from short-term volatility. Being an open-ended defined benefit scheme also helps as the returns required from our real estate portfolio are not huge.

Spencer: It is hard to know when the market has yet to settle. But as we open the timescale up 10 or 15 years, what we can look for are the core portfolio characteristics.

The potential for real estate to outperform inflation means it plays a valuable role. Where are we going with inflation is unclear. To me, investing directly in real tangible assets has value against this uncertainty. Over the medium term, it has an incredibly valuable role.

The other aspect is the dislocation. Managers like this because there is a big role for alpha, and there is a lot of potential alpha in the market at the moment, albeit depending on the strategy and sector.

Ward: Although inflation might hit short-term returns by keeping rates high, long term there is likely to be a level of inflationary linkage to rents – and explicitly in some cases.

High inflation will, therefore, hurt short

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Adrian D'Enrico
Fund manager, affordable housing
Edmond de Rothschild
Asset Management

term, but possibly help longer term. It will be interesting to see how that plays out and impact pricing.

Sumpster: As a result of the LDI situation that played out late last year, there has been a review of people's liquidity requirements. To a certain degree, portfolios are now more liquid.

When we think about that illiquid market, which a good part of real estate is exposed to, over the longer term it presents a yield pickup to public markets. There is a place in pension schemes for that because we have to solve the situation of many pension funds, certainly defined contribution, not paying out anywhere near the sums expected for people to maintain their lifestyles.

There needs to be the opportunity for defined contribution liabilities to invest in private markets.

Today is probably not the right time, but planning for that opportunity when we are in a more stable environment is something we would welcome as a holder of a significant pool of defined contribution liabilities.

> **There needs to be the opportunity for defined contribution liabilities to invest in private markets.**
>
> Tom Sumpster
> Head of private markets
> Phoenix Group

Are people demanding sustainable properties?

Warden: Absolutely. It is becoming more black and white in terms of tenants not wanting a 20% discount on their rent because the asset is not sustainable. They have made net-zero commitments and therefore that space does not measure up. It is a yes or no question. The sustainable space will continue to do well.

I sense a supply and demand imbalance coming up.

Warden: Particularly because developments have stalled due to a lack of financing. So sustainable assets, especially in the office sector, that come to market soon will see strong demand and perhaps command higher rents.

Occupiers look at how much it costs to occupy a property as a whole including rent, service charge and operating costs, and generally, sustainable real estate is more cost effective to maintain. This gives them potentially more room to pay higher rents. The all-in costs are quite important to tenants across asset classes.

Ward: Are you seeing that across all sizes of property?

Warden: It is being driven by larger companies. For anyone needing office space over 100,000-square foot, it is generally an absolute requirement. Interestingly, when inspecting our direct portfolio, which is across the UK, sustainability was a common theme of discussion amongst our tenants.

For some, it is because of requirements at a corporate level, while for others it is expensive to operate these buildings so they want PV panels on the roof to access cheaper energy, for example.

Ward: It is good for getting longer leases as well. For a 25-year power purchase agreement why wouldn't you sign a 25-year lease, which is value accretive for you, the occupier and the environment. There are ways that everyone can win.

Spencer: This is another part of the differentiation which is opening up in the market. Energy costs will not fall any time soon, added to which stricter regulations, requirements and minimum standards are coming.

In the US, there are already differentials on taxes based on energy efficiency. If this is already happening in the US then we should expect it to come to Europe.

With property responsible for 39% of greenhouse gas emissions, there is going to be much more emphasis on energy. Governments will offer carrots and sticks to help meet energy efficiency goals.

Baigler: If you are a large corporate, there are two ways of reducing your carbon footprint. One is your headquarters. You cannot occupy a building if it does not hit every low carbon and energy efficiency standard.

The other way is to stop international travel. You cannot change how your employees get to the office. What you can change is the office they are in and how much they move around once they work for you. Real estate has a huge role to play here.

On the other side of this is making sure that your buildings are energy efficient. The mantra is you need to buy high carbon buildings and sell low carbon buildings.

Within that you have the development

process. It is all very well building an energy efficient property, but that's not much use if you have generated a huge amount of carbon creating it. The only way to reduce your carbon footprint in a new development is to not develop at all. This means repurposing old buildings. That is more expensive, but it will be reflected in the rent.

It is a virtuous circle. A corporate will pay you a higher rent because they have to be in a new building, and a developer refurbishing a building is going to have to create it in the most carbon efficient way possible. A lot of this is going to fuel itself.

Spencer: The new demand is to consider at the broader impacts beyond energy. Particularly water use within buildings and how it gets back into the ground. This is unleashing a lot of innovation and creativity.

It is not just thinking about the energy envelope, but we are going to start expanding this conversation.

We have just about got our heads around embedded carbon, but now we are starting to think about how we are using all the resources. It also includes social use and inclusivity which will impact demand which is the mainstay of valuations and value.

Ward: With the E in ESG, we have a good idea about tenant behaviour drivers, regulation and the potential emergence of tax related to environmental performance. How can you do a cost benefit analysis on things like biodiversity though? It is difficult.

If you are spending millions of pounds more, and you are not getting a tangible value driver, that for me is hard to sell. But you know it is the right thing to do, so I can't quite square that circle.

Baigler: It's the liquidity point, right? If your building does not comply with every regulation and is not as environmentally friendly as possible, pension funds will not buy it.

You are then going to get a bifurcated market of a secondary world of people who are prepared to buy inefficient buildings and a core world where you have liquidity and a value-add existence of taking inefficient buildings and delivering them.

Ward: I understand that on net-carbon emissions and on various other measurable environmental metrics. What I was alluding to is that biodiversity is more difficult to measure. It is these softer measures which are not yet a core part of the reporting regime.

I find it harder considering things you cannot put in a spreadsheet, when you are paying more for them.

D'Enrico: We get that on social. In the past 20 to 30 years, we have made progress by focusing on the E. We have a lot of measures and standards to assess that, but the S is a nebulous thing that we have not agreed how to measure. It feels right, but it is hard to quantify and price.

We need standardised reporting measures from a social perspective. SFDR Article 9 is useful, but our assets are sustainable by virtue of being social housing. There is no more detail on that framework for us to show that we are doing it better than others. That needs to come through so we can work out where we are relative to our peers, what we need to improve on and what we can deliver.

Baigler: A lot of this is going to end up being a value protection exercise, rather than value creation. All that will happen is that you will start losing tenants.

It is intangible and regulation always lags the market, but it is going to get to the point where if you are not doing what you need to do to your building, value and liquidity will drop.

Spencer: I have seen managers put a price on everything from social to the natural world. Within sustainability, there are mixed emotions about doing this: how can you put a monetary value on inclusive design?

It will get better, but in the meantime more sustainability is de-risking. Socially inclusive design makes it more available, so that you have more buyers because they want to be in an inclusive property.

Baigler: We have seen this before in less dramatic scenarios. When the Disability Discrimination Act became law it was clear that you had to have inclusive access to your office. There was a blind panic about the stairs. "I will never sell this office."

You start retrofitting. There is a cost implication and the value of the building has not gone up because you have created a complex ramp system. All you have

ESG penetrates every area of real estate investment.

Louise Warden
Head of real estate
Local Pensions Partnership Investments

done is maintain liquidity in your building. We are now looking at a far larger, far more complex identical situation.

Sumpster: With the Article 9 situation, whilst you may not see additional value for areas not yet captured, you are future proofing and creating a certain type of brand, which is appealing to investors even if it costs a little more on yield reduction. We see the value in the long-term investment.

It is an exciting opportunity. As institutions with large capital, we can influence the way developers think about their buildings, but equally we are excited about the market leaders who are taking us into an ESG environment that is here to stay. The regulations around that will only get stronger, as we are seeing in the car industry.

Spencer: We have the potential to go through the next 20 to 30 years in a way that is radically different from the previous 20 to 30 years.

Sumpster: There is a generational change as well. People are growing up living with ESG and will be making investment decisions in the future based on it.

Baigler: Eventually there will be a regulatory standardisation. At the moment, you can get green certifications for your buildings in 10 European countries which include 10 acronyms. I cannot tell you what each acronym means, but this is all heading in the right direction.

Ward: Our equities team says ESG standards for property are highest in the UK, the Netherlands and Scandinavia. You have a pan-European portfolio, so how do you deal with softer regulatory regimes? Do you assume it will harmonise at some point?

Baigler: While certain countries clearly lag, if you are creating an institutional product, the pool of investors is quite centralised. You are correct that the wealthier European economies are leagues ahead in terms of sustainability and environmental compliance. One thing most European countries hate is when you turn up and tell them what they need to do to their buildings. But that is the reality. If you buy a warehouse in Spain, you need to comply with the most advanced regulations, which invariably are Scandi or in the UK. Even if those regulations do not exist in Spain they will one day, so I need to do this now otherwise I am going to fall foul of my own liquidity.

The only way to reduce your carbon footprint in a new development is to not develop at all.

Charles Baigler
Head of acquisitions,
direct real estate
Pictet Alternative Advisors

ESG-compliant properties are in demand, so how do you prove that such assets are sustainable?

Baigler: Every asset we acquire, whether it is for long income, core or a value-add programme, is part of an ESG strategy.

Ten years ago, we were asked, what's your business plan? What's your capex? Today we are asked, what is your ESG strategy? Spending X millions of pounds to hit your targets will be a normalised part of a business plan. Then, invariably, you will need to think about what else you can do because you have a two-year business plan and regulation is almost certainly going to change in that time.

It is not about putting solar cells in or extra bike parking to charge an extra 10bps. You have to assume that if you don't do this, no one would want to buy the property. It is a defensive measure as much as it is necessary.

Spending on ESG is now part of the real estate universe and is being driven by the market because the liquidity will disappear.

What do you look for when selecting a real estate investment manager?

Warden: Sustainability is key to everything we do as an institutional investor. On the direct side, we have our partner KFIM managing assets to ensure they are aligned to our net-zero targets.

In terms of overseas managers, we definitely ask when the portfolio will reach net zero and what is the ESG plan.

The answers we get vary in terms of the regions we look at. Some of our UK and European managers are ahead of the curve. Australian managers seem to be way ahead, but some of our US managers are lagging, making it difficult to aggregate information at the portfolio level.

It is about engaging with our managers to align them with our path towards net zero.

Sumpster: When we are awarding mandates to managers, there is a meeting of ESG teams on both sides. If there is not an ESG team on the other side, we simply are not going to invest. It would suggest that they are not taking ESG as seriously as we would like them to.

When we beauty parade investment managers, that ESG relationship needs to get over the line. It is important to align our ESG policies with the way asset managers invest on our behalf.

Spencer: It is better than three years ago, when there were a large number of managers who could barely spell ESG. These days anyone who cannot spell it cannot take part. A good manager can create double wins in terms of value creation and cost. I remember a story about renewable lighting installed in a car park. It had a payback of 18 months making it the fastest asset management value-add in their plan. So rather than having a sprinkling of words and general fuzziness, investors are looking for tangible and real examples.

D'Enrico: It is the integrity and transparency of what people are doing. If after the event they hire an external party to produce an ESG report, then it is not central to what they are doing – it's an afterthought.

A social impact adviser works with us from the first assessment of any opportunity that come across our desk. They also produce an impact report that is central to our due diligence for acquisitions. They then produce an annual report that critiques our social impact performance – this ensures we are continually assessing and adjusting the portfolio.

I have seen managers where impact is not embedded. It is just something that is measured afterwards. If it is central to what you are doing, it is something you will do throughout the investment process and holding period.

Warden: ESG penetrates every area of real estate investment. Managers who are not doing it are missing out. It is a risk like any other investment risk. If they have turned a blind eye to it they are not at the cutting edge.

What trends do you expect to see in real estate during the next five years?

> **Once we hit fair value, it will restart the competition for the best quality assets.**
>
> Ben Ward
> Head of matching plus and property
> BAE Systems Pension Funds Investment Management

Sumpster: I would hope this country gets its act together and supports the levelling up agenda across party politics. There is a long-term programme of investment opportunities based on regeneration through affordable housing, residential homes and commercial properties being developed that will create a better society.

It feels like it is coming. I attended the *Convention of the North*, where Michael Gove and the metro mayors were quite vocal around this. Devolution is important to remove the red tape around local investment.

When that happens there will be a suite of opportunities for long-term investors to take hold of.

Ward: We will see a changing dynamic of who is buying and who is selling. The de-risking of DB pension schemes, larger DC funds coming back into the property space, the relaxation of Solvency II and an enormous glut of private wealth around the world will change the demand dynamic. It will be interesting to see how that plays out.

D'Enrico: Local authorities, housing associations and public bodies are financially constrained. There is an acceptance that private capital is increasingly essential to help develop accommodation across the affordable housing space – there is long-term alignment.

We always hear that there might be some headline risk of coming into these spaces but for me, the bigger headline risk investors face is going to come from not being involved. If you are not contributing to a solution, are they part of the problem?

Baigler: We are going to see a quite severe bifurcation as real estate becomes more institutionalised in the UK and Europe. Some assets are going to become obsolete faster than we perceive, while others are going to be in greater demand from a larger pool of institutional investors.

Ward: Interestingly no one mentioned tech. Whether that is digital securities for real assets, whether it is improving transparency on ESG or enabling occupier behaviours, it is gaining traction.

I don't know how that will play out, but it is another interesting space to watch.