pi REAL ESTATE roundtable

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DISCUSSION: REAL ESTATE

Real estate is an important indicator of the trends driving our economies. How the properties we live, work, shop and relax in are changing reveals how our lives are evolving.
So what do consumers and tenants want from bricks and mortar today? To find out, *portfolio institutional* assembled a panel of insiders to discuss the institutional property market.

Anthony Doherty opened the discussion by stating that beds and sheds have been the consensus trade in the past five to 10 years, but the search for growing and resilient cashflows has brought life sciences, digital, renewable assets and more forms of housing into the picture.

These sectors are typically characterised by a supply-demand imbalance and "pricing power" – where business models are better positioned to pass on cost pressures – which are influencing institutional investor decisions. "Investors are still looking to grow their capital, which has always been the case," Doherty said. "It is just about having the right framework to identify the right themes and investments to deliver it in today's market."

Pension pool London CIV had around £600m of commitments across three property funds at the end of December. Christopher Osborne explained that allocations focus on property sectors that are essential to society's physical needs, such as housing. "There is a considerable supply-demand imbalance as the UK is simply not building enough houses. This reduces void risk and leads to high occupancy rates with low tenant turnover."

He added that housing associations are no longer bringing as many houses to the market as they once did because debt is expensive and they are focused on upgrading their existing stock to meet environmental regulations.

To help meet demand and drive inflation-linked investment returns, London CIV has a UK affordable housing strategy. The pool also has exposure to student accommodation and education assets through its Real Estate Long Income fund and data centres through the London fund, a collaboration with LPPI. "Again, these are sectors we feel are essential to society today that can drive stable and resilient cashflows, where there is low volatility and potential for capital growth," Osborne said.

The asset class also plays an important role for Nest in providing stable returns and diversification. The master trust has 5% of its assets invested directly in property and a 2% allocation to global REITs (real estate investment trusts).

Expanding its international exposure to the asset class may not be easy. Anders Lundgren is seeing older funds that are heavily weighted towards legacy assets like offices and retail, which he has seen as high as 70% of the portfolio.

For a fund to interest Nest it would have to be heavily exposed

to residential, logistics and life sciences. "We would still have retail in there, but would want it to be less than 10%," Lundgren said.

Build-to-rent also interests Nest due to just over half of the 440,000 new homes the UK needs each year are entering supply, Lundgren said. He describes the market as "a growing and interesting area that gives us an element of affordable housing".

> **To make an asset sellable or tenanted, a number of companies are demanding greener or more net-zero buildings.**
>
> Sarah Acheson, Cambridge Associates

Another pool committing capital to real estate in search of not only income but inflation protection over the longer term is Local Pensions Partnership Investments (LPPI). It has the local government funds of Lancashire, Berkshire and the London Pensions Fund Authority as its partners, so is targeting regional assets as part of its real asset strategy. "Increasingly, our clients are looking to real estate and infrastructure to meet their local investment objectives," Louise Warden said. "So all three of our clients have local portfolios that we invest on their behalf, in addition to a broader portfolio of diversified real estate assets."

However, it appears that property's role in institutional portfolios of providing certainty of income, sometimes linked to inflation, is under threat, according to Simeon Willis. "The challenge now is that other assets are competing with property by providing a liquidity premium alongside a steady stream of contractual cashflows," he said. "But more fundamentally, gilts are now offering a guaranteed healthy return above inflation."

So property's main selling point is under pressure from low-risk assets. "That creates a bit of tension in the market, which we are in the midst of," Willis added.

Bill Page picked up the theme by explaining that real estate yields still have a journey to go on to offer fair value relative to gilts. "There's a destination that looks more appealing where real estate offers a premium over safer asset classes like debt. When it can do that, it becomes a more interesting place to be."

Page added that before we reach that destination, there are parts of the real estate market that are delivering even with a

THE PANEL

Sarah Acheson
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Bill Page
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Louise Warden
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higher risk-free rate. "Residential and parts of industrial are still seeing very good income growth," he said.

Debt or equity

It was mentioned earlier in the discussion that debt is expensive, but is that deterring many investors from borrowing to fund their real estate strategies?

"At the moment, debt ticks a lot of boxes because if it is properly structured with sensible loan-to-value and interest cover ratios as well as having good covenants behind it, it can offer an attractive yield relative to real estate equity," Page said.

Sarah Acheson added that in today's real estate market debt offers an attractive return, particularly on the senior lending side, and is seen as a slightly safer option. "You essentially are able to achieve double-digit returns, in some instances, without taking a significant amount of risk.

"So there is an outsized opportunity in debt markets," she added. "More investors are looking at that as continuing to be a compelling opportunity to access real estate because they are seeing that there could be further pressure on equity."

The price of money

One major influence on property yields are interest rates. They started rising around 18 months ago after being anchored below 1% for more than a decade, but in the closing weeks of 2023, the rate curve lost almost a point.

"We have moved on from the 'how high are they going to go' to 'how long are they going to stay at this level' debate, which is a welcome development," Doherty said. "And we are beginning to see risk assets rally and sentiment change in capital markets."

He added that stability is beginning to return, which bodes well for risk assets in the year ahead, although he warns that these are early days.

In an environment of rising interest rates, lower yielding assets that typically look like bonds don't do well, Doherty said. "There wasn't much hiding space for industrials or long-income assets in 2023, for example, because bond yields moved out 200 basis points. It was quite obvious, therefore, that pricing of these assets needed to move out too, whereas assets that

Simeon Willis
Chief investment officer
XPS Pensions Group

already had good income levels were less impacted," he added.

So what impact will higher for longer interest rates have on property yields?

Page pointed out that property yields are not only influenced by interest rates but rental growth and how much debt is in the economy are factors, too. "But where interest rates are at the moment suggests that yields should be higher," he added. "So there is risk."

When it comes to the sectors that interest rates will impact most, low-yielding and mid-yielding property with less growth potential, like offices, on average, look more challenged. "They still have a journey to go to re-price to fair value," Page said.

Nest has decided to invest in gilts again after a long pause. "We did not invest in gilts for many years because we didn't want negative-yielding assets," Lundgren said.

He added that credit is yielding 6% to 7% and you can earn 5% on cash. "Investment grade is okay and high yield has been doing well, but a maturity war is coming from 2025, so you have to be wary of that.

"I guess the big change is that the fixed income component now delivers, which it didn't before, so the worst is over in UK property," Lundgren said.

Willis pointed out that pension scheme funding levels typically improve when interest rates rise, so they will be looking to manage their liquidity ahead of attracting an insurer in the near term.

> **"We are beginning to see risk assets rally and sentiment change in capital markets.**
>
> Anthony Doherty, Legal & General Investment Management

Insurers want less illiquid assets, as they incur higher capital charges on the balance sheet, Doherty said. "So by hook or by crook, some of those assets will need new owners," he added.

But at the time of the discussion, property funds were typically trading at a discount to their net asset value. This, however, is not as bad as it seems in this higher interest rate environment. "You can earn 5% per annum risk free," Willis added. "So if you sell something at a 10% discount to have the flexibility to insure your scheme in the near future, it is only going to take you two years to earn that back through investing at the risk-free rate.

"The higher interest rate environment creates a few dynamics for pension schemes," he said.

The future workplace

The office sector has endured a difficult period since Covid but Page is optimistic, expecting the market to reprice soon to a level that can compensate for the risk taken.

"Before Covid, and with the benefit of hindsight, I don't think yields compensated investors for the risk of owning and running offices which are complicated and time consuming. But there is a chance the repricing will provide the risk premium that we have been wanting to see for quite some time."

Page added there is a big slice of the market where conditions are "challenged" but he is seeing a "compelling performance" in the good offices where there is competition between occupiers for space. "That is quite exciting."

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> Anders Lundgren, Nest

He has also experienced a change in thinking when it comes to location. "We are increasingly looking at London and the most vibrant cities for office assets rather than across the UK. So it is a different market, but is on the cusp of being something more exciting than it has been for a few years."

Acheson shares his optimism. "There is always going to be a place for offices within a diversified real estate allocation," she said, adding that since the pandemic there has been even more of a bifurcation in the market on what a good office looks like. "A good office meets the needs of workers so it will not be designed to cram in as many desks as possible.

"People aren't plugged into monitors anymore, they work on laptops," Acheson added. "So they need less desks and more breakout areas within the office."

For secondary or tertiary stock, investors may need to think about an alternative use for some of the older buildings that aren't in high demand locations. Hotels and houses are two options. "There are opportunities to effectively change redundant office buildings," Acheson said.

But Warden warns that valuations are not where they need to be and we still have some way to go in the repricing. "We are definitely seeing a disparity across the market in how people are valuing their office assets and factoring in the cost of regulation."

These costs include retrofitting offices to meet energy efficiency standards. This is a big task. PwC says that 90% of the UK's 60,000 offices do not meet the required standards. The cost of retrofitting them by 2030 is estimated to be £65bn. "That retrofit will be built into some valuations, but I suspect not all as yet," Warden said.

Despite the cost of making sure an asset is regulatory compliant, Doherty believes overseas capital still likes prime London assets. HSBC moving to St Pauls was cited as an example. "It is a market overseas investors know; it is liquid and offers the opportunity for larger lot sizes.

"Don't get me wrong, transactions are far down from where they usually are, but for the best assets there can be some interesting returns," he added.

So despite Covid, London still appeals to investors, Warden believes. "Liquid and with a strong legal structure, people still see the UK, and particularly London, as attractive," she said. "Also our real estate markets have repriced quicker than other parts of the world. That adds to the attraction."

But Doherty believes that despite the positives Warden listed, the UK has been put on the "naughty step" due to Brexit, the mini-budget and political turmoil. "Some investors, particularly in Europe, have put us on a different volatility coefficient. We are now in a different, more volatile, bucket. That has stopped some investment in the last few years.

> **If you get the environmental right on housing, then you have a social impact as well, because there will be lower household bills.**
>
> Christopher Osborne, London CIV

"But on the flip side to that, there are an awful lot of investors are who underweight the UK, so if we can have some stability with interest rates and perhaps even in politics, then there is something positive to play for next year," Doherty said.

And Acheson sees the re-pricing story as positive in that the US and other large real estate markets are repricing slower. She cites the logistics market across Europe as an example. "The speed of recovery almost seems to be slightly faster this side of pond and will positively impact people's view of the UK. "When they are looking at relative value across the globe there could be more opportunities there."

Acheson added that the UK is seen as an international hub for capital and that we are a recognised global provider of education, with the rise in life sciences and technology development benefiting Oxford and Cambridge. "Those two globally recognised hubs are going to positively impact the real estate market, not just in London and the major cities, but in those two hubs in particular."

Osborne added that investors are realising that perhaps the non-traditional property sectors, such as education, have become a lot more institutional. "There is the opportunity to maybe pivot slightly into those non-traditional sectors and reap the rewards of good cashflow growth and solid fundamentals on supply and demand."

Willis agreed that the UK's property market is attractive, but the market is struggling with uncertainty resulting from political decisions. One is the change in RPI, which affects the contractual obligations that sit in many rental agreements.

The other is the proposed cap on ground rents, which is likely to reduce the return investors earn.

"Uncertainties and question marks introduce doubt," Willis said. "You want to be in a category where people don't have to worry when they are investing."

Local assets for local people

As previously discussed, LPPI's three partner funds invest in commercial and residential properties in the local regions, which not only help to generate a return but also make a social impact where their members live and work.

> **Residential and parts of industrial are still seeing very good income growth.**
>
> Bill Page, Legal & General Investment Management

Focusing their property interests purely on the capital is something London CIV has considered. "All of our 32 London boroughs would love to have investment in their backyard, but we have to take a backseat and decide if that is in their best interests, in terms of paying pensions," Osborne said. "We have a UK affordable housing strategy as we felt there was a better platform of investment opportunities if we made it nationwide."

However, they still target London, where there is a huge need for affordable housing. "When we invest alongside partners in the affordable housing space, we often negotiate local co-investment rights, which means priority co-investment rights within London, if they become available at reduced economics," Osborne said.

"We look at more creative ways to access local investment opportunities in London. But first and foremost, it is about the risk/return."

For Osborne, there are opportunities for London CIV to extract and preserve value from affordable housing. "The lack of supply means that you don't see a great deviation through different economic cycles in terms of vacancy rates," he said. "So occupancy throughout the pandemic and post mini-budget crisis remained solid and the amount of bad debt in terms of missed rental payments is low."

Positive impacts

Although earning a return from property is the main driver for gaining exposure to the asset class, there are other goals investors want to achieve.

Nest will also be focusing on making a return when it looks at a built-to-rent strategy, but it will include a high social element. "What we don't want in those properties is that affordable tenants are treated differently, and that they have access to all of the amenities. That is important. We have 12 million members, so some of those will be our tenants as well," Lundgren said.

But one of the biggest ESG impacts property needs to make is not a local issue. Real estate is playing its role in the energy transition with investors funding renewables. "We are building up investment capability in renewables, where an investment of more than £800bn is needed for Europe's Green Deal by 2030," Doherty said.

"So we have broadened into that space to provide our investors with another avenue to resilient cashflow growth," he added.

Cambridge Associates focuses on ESG in every investment

decision it makes, with some of its clients having impact-only portfolios. But it is not just investors who have set net-zero targets. "To make an asset sellable or tenanted, a number of companies are demanding greener or more net-zero buildings," Acheson said. "Those are in short supply and that trend is only going to continue.

"So you have to think about this," she added. "If you aren't, then you are either going to miss out on capital or be stuck with illiquid assets that you are selling at a huge discount."

You might think that it would be easier to incorporate environmental objectives within property than a portfolio of debt or public equities. But Willis said that real asset funds are lagging public market funds in a number of the key measures.

> **"Our real estate markets have repriced quicker than other parts of the world. That adds to the attraction.**
>
> Louise Warden, Local Pensions Partnership Investments

"For instance, almost half of the real asset funds we looked at could not provide a credible example of how they have captured environmental considerations into their fund," Willis said.

It sounds easy to understand how green a property is by looking at if it is being powered by renewable sources of energy, but it appears to be difficult to get hold of that information. Such data is more readily available in the public markets, given the frameworks that exist, such as MSCI's standard framework for carbon reporting.

Acheson called for clear guidance on what the standard for real estate should be, particularly when it comes to reporting all three scopes.

Osborne added that harmonisation and standardisation of reporting are crucial. "When we look at managers, we assess their ability to generate social and environmental impact, what they are measuring it against and how they will report that to us."

So creating sustainable properties is not just about avoiding oil and gas. There are social factors to consider, too.

On this issue, London CIV has worked closely with Big Society Capital, which has established a set of standard metrics for affordable housing.

Nest works to ensure that the receptionists and cleaners in their properties receive sick pay if needed. "We don't want this zero-contract work. It is important to us that all of the staff are taken care of," Lundgren said.

For Osborne, the social side is becoming more important for investors. "It is intertwined with environmental," he said. "If you get the environmental right on housing, then you have a social impact as well, because there will be lower household bills."

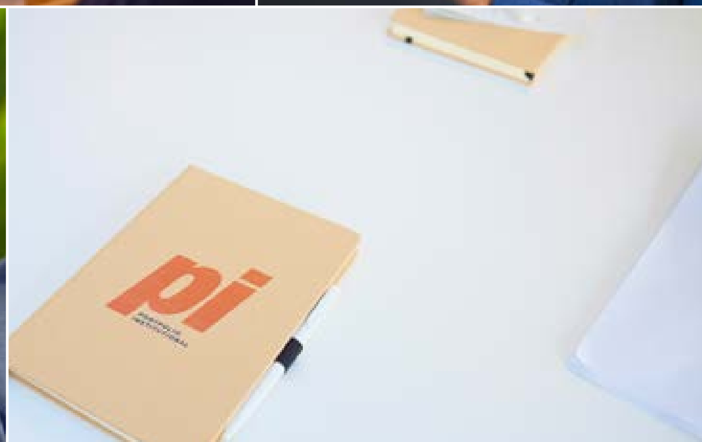
This includes installing air-source heat pumps, which remove the need for gas. "Furthermore, if you get the social elements right and engage with all the different stakeholders, then you have a better chance of unlocking the financial returns. It is not optional anymore," Osborne added.

A big opportunity to achieve such goals is to invest in development to create more energy efficient homes, and therefore lower utility bills for the resident.

Another benefit of development is that the returns are higher, Doherty said. "We are in an environment where interest rates are high and investors want growth. It's about funding areas of need. So we are seeing capital a bit more interested in development and new build for all those reasons."

What's next?

So what do our panel believe we will see in the institutional property space in the coming year? Well, a greater push on ESG, commercial downsizing and more investment in data centres are expected.



"Beds and sheds will still be the consensus trade, but a few will break ranks with perhaps offices, perhaps something more counter cyclical," Page said. "Hopefully, there will be pricing certainty to allow more traction in the market. That is closer than we think."

> **The challenge now is that other assets are competing with property by providing a liquidity premium alongside a steady stream of contractual cashflows.**
> Simeon Willis, XPS Pensions Group

Willis does not expect to see a change in general appetite from defined benefit investors. "We could see an acceleration if yields spike and schemes are put under liquidity pressure. They may then have to sell along the lines of what they have been doing for the last 12 months."

On the DC side, he is not expecting a radical change in 2024.

Lundgren, meanwhile, predicts that with people still working from home, the trend for companies downsizing their offices will continue. While Osborne expects there to be a need for more data centres as we are consuming more information. "That market will continue to thrive," he said.

ESG will continue to influence property investing, Acheson said. "There will be the continued acceleration of ESG in all of its different parts," she added. "The number of companies who are forming an impact-focused fund who have pitched to us in the last year has increased.

"That will be a continued theme in terms of carving out impact in some shape or form."

Warden wants to see more repricing, which she hopes will happen globally rather than just in the UK. She believes that we could also see more consolidation and aggregation across the market. "Whether that be amongst managers or portfolios – we will have to wait and see."

Finally, Doherty closed the discussion by saying that it has been a challenging 18 to 24 months in the real estate market but offered a positive outlook. "I'm going to bank the last eight weeks of positivity on risk assets and reducing interest rates. Who knows, we might have a tailwind on the capital markets in 2024."

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