Real Estate Opportunities in the Post-Pandemic World

On November 30, 2021, Hubbis and Principal Real Estate Investors held a through leadership discussion event attended by wealth and asset management experts in Asia, and with two key leaders from Principal in attendance, namely Andrew Thornton, CEO of Principal Real Estate Europe, and Giles Smith, Head of Fund Management Europe at Principal Real Estate Europe. The mission of this off-the-record discussion was to analyse the demand for and availability of real estate opportunities in specific markets, especially the US, Europe and Asia. And they should certainly be in the know and in the flow, as the Principal Real Estate Investor Platform today manages around USD98 billion of real estate assets globally, making it one of the largest real estate managers in the world.
THESE WERE SOME OF THE QUESTIONS ADDRESSED AT THE EVENT:

» What are the best real estate opportunities as we move into the next stage of pandemic recovery?
» Do you expect to see demand for these types of investments to increase in 2022?
» What sectors are you focused on and why, for example logistics, data centres, healthcare facilities and others?
» What countries are you focused on and why?
» What are the benefits of investors looking outside their domestic markets, and why does Europe offer diversification benefits?
» How do you engage these opportunities for your clients?
» What risks might appear next year?
» How do these investments fit into a typical client portfolio?
» With potentially a rise in inflation in the coming years, are these investments becoming even more compelling?
» Who are Principal Real Estate Investors, and how can the firm help deliver interesting opportunities for Asia’s private wealth community?

Hubbis has summarised some of the selected insights and observations in this report, with the chosen comments from the two Principal Real Estate Investors (Principal) leaders quoted as on-the-record and any other views from the selected guests – all wealth management institutions, asset managers, family offices and investors - are relayed on a non-attributed basis.
SELECTED COMMENTS FROM THE GUESTS

The guests offered many personal insights into their approach and the preferences of their clients. We have selected just a few such observations to add weight to the overall discussion:

The real estate investment goalposts are constantly shifting
An Asian-based investor reported how it has been very difficult to get things right in recent years. In particular, he has been constantly surprised by the sheer weight of capital chasing deals, especially logistics. A prime Milan property they bought several years ago at a 3.7 cap rate was recently valued at around a cap rate of 3. For some sectors, such as offices and retail, meanwhile, there is often little institutional demand. However, he indicated that the potential flow of distressed asset opportunities had been increasing.

Some prefer the residential real estate market, but any distressed sectors appear to have stabilised
Another guest reported that they continue to focus on residential real estate in the US, in Europe, and in Australia. They took advantage of some distressed opportunities in the US last year and continue to look out for those opportunities, but he indicated the bounce might have already happened and the discounts they had seen in 2020 are disappearing. “That train might have left the station already,” he said.

He indicated they continue to focus on affordable housing and multi-family homes. They are looking at Spain currently, particularly developer led deals where funding from the banks is difficult to obtain. “The big difference between now and 10-12 years ago before the Global Financial Crisis is that a lot of leverage used to sit with the banks, and much more is now sitting in the private market today,” he reported.

The rising prominence of ESG and impact in real estate investing
A guest highlighted the rising importance of ESG in real estate investment decisions for private clients, who are especially cognizant of the E of ESG. Environmental considerations had come even further into the foreground since the pandemic hit, he remarked, and added that the S for social impact was also gaining ground in decision making.

Societal matters can be crystallised in social housing, which improves lives and help boost investor integrities
The same guest pointed to the rising importance of social housing investments that also produce profit and in which the private sector can play a key role. “We’re talking about obviously in the US markets the preponderance of multifamily, which is gradually being replicated across Europe, and, depending on the price of land and construction, it will ultimately come into Asia,” he reported. “We’re also seeing the provision of disabled housing, and we’re seeing disadvantaged housing becoming an asset class in its own right.”

He explained that investors are not necessarily accepting a lower yield, but requiring a more diversified return, with the return a combination of income, which is in many instances government supported, and the growth of the underlying asset, as well of course as the social benefit. “Indeed, I am wondering how to make a social benefit fungible, like a carbon credit, because that may well be the third component of the overall return. In this way, you are on track to a full-purpose investment that’s of appeal not just to institutions but also to philanthropic endeavours and larger family offices. We are seeing this emerge.”

Some of the guests debated the importance of government support on rentals and possibly mortgage payments, especially where more and more middle class are priced out of owning property due to the sheer cost of building enough equity and then buying into residential assets. But there was a general consensus that government and state need to steer clear of the investment side and focus more on the social support elements of the social housing, in whatever form it might take.

Singapore might be the social housing model to emulate in Europe
The same guest pointed to the appeals of the Singapore social housing model, which is an ownership model in which anyone can participate, even those with large incomes. “It is a beautiful design by a former finance minister, Dr.
Goh Keng Swee,” he reported. “To finance public housing, they issue bonds by DBS, Singaporeans buy the property financed by DBS, which will actually recycle the capital back to the system, so it is very well balanced. Maybe the European community should take a look at Singapore’s model. Your property is well mortgaged, well financed, and demand is robust. But it is an affordable ownership model for flats up to 5 rooms, rather than a cheap rental model.” A major by-product is that Singaporeans in these HDB flats are extremely house proud, there is a strong sense of community and crime is incredibly low.

**Family office money in Asia loves property and is constantly seeking new investment avenues around the world**

A guest who manages the funds of several wealthy families explained that his clients like property and have plenty of exposure across Asia and also into the UK and Europe. He explained that they like to access investments such as student housing as an alternative to fixed income, as it has been producing 7% to 8% annually for the past 15 years roughly. And he said there is minimal, with surprisingly good liquidity for property.
Observations and Comments from Andrew Thornton & Giles Smith

The changed and changing world we live in is leading to evolving outlooks for real estate and some tendency for investors to take on more risk in key segments that have performed especially robustly

Thornton explained how the European markets had been fascinating to watch since the pandemic hit, forcing them to change the way they think about real estate. A key factor he highlighted is that, like Asia, Europe is fragmented with a large number of countries, each of which has had responded in a very different way through the pandemic. “We have seen far fewer international investors travelling to Europe, with a dramatic downturn in Asian visitors, for example, resulting in greater domestic capital employed. The residential and logistics markets, like the US, have been very strong, offering pandemic-resistant strategies, and food retail has also been robust. Pricing is now strong in historical terms and actually challenging conventional thinking, inclining people towards taking more risk on, for example, moving into more development rather than buying standing assets, and that approach is seeing some good performance and good returns.”

Specialist sectors have come into more focus during the pandemic

Thornton also reported that there had been a trend towards specialist asset classes, for example, seniors living facilities and self-storage, health care, medical office, and data centres. “Supply constrained markets are probably the most interesting in general,” he reported, “and that’s why Europe hold considerable appeal.”

Returns in the logistics sector move into double digits, and demand remains particularly robust

Smith told attendees that returns for core logistics in Europe are now in the double digits, driven by the huge demand from operators for logistics space, as well as the trend towards localised supply chains and the continued dynamism of online retail.

“But how sustainable are those returns? He pondered. “And where to invest looking out over the next two to three years to make sure we benefit from any rental growth that’s going to come through? Yields for large logistics units, particularly if it had a really strong lease such as Amazon and a 5- to 10-year term are now sub 4% net initial yields, actually sub 3.5% in some places for core logistics. Is that sustainable? Is that on the basis of rental growth coming through?”

Yes, he replied, but said that different markets have different factors to consider, for example, there is a lot of land to develop around Madrid for new facilities, but not around Barcelona. And there is a lot of bespoke requirements for developments nowadays, with names such as Amazon and other retailers, third-party logistics providers specifying very bespoke construction to help them with their picking and sorting supply.

“That then we must wonder if in 10 years’ time when that lease comes for renewal, will that technology have moved on? Will there be new specifications? Can that unit be easily leased in the open market? But for the moment, there is sustained demand and a slightly more constrained market of last-mile logistics, with a number of European cities still very undersupplied when it comes to the last mile, where we’re certainly looking at acquiring assets and we expect to see rental growth to continue.”

He added that the last mile element is also important from an ESG perspective because the use of electric vehicles by third-party logistics providers is increasingly important. “And of course, you need charging points because of the range constraints,” he noted. “In short, last-mile logistics is a big focus for us.”

Offices – on the cusp of extinction or due for a major bounce-back. In short, what’s next?

Smith turned the spotlight onto offices, explaining that the firm had done a lot of research on this sector and its potential resilience in the post-pandemic world. “The UK tends to mimic the US, namely low return to the office after the first lockdown, but continental Europe, France and Germany, in particular, saw 60% to 70% of staff return to the office, and that’s coming through actually in the assets we
manage. We are therefore seeing strong demand for well-located, flexible office accommodation in cities such as Frankfurt, where tenants have flexibility, they can take or expand will take less space, shorter lease terms, but also the provision of more facilities to tenants.”

And he said there is also an ESG angle. “We recently acquired a new asset in the Netherlands that was developed to the ‘Well’ certification, which rates the wellness of the occupants. And we have been very encouraged by the level of tenant demand as we marketed through the pandemic, with companies wanting to offer their staff something additional in terms of their experience in the office building. It was not only 100% pre-let on completion, but we also achieved rent at the upper end of our forecast and at a significant premium to competing assets that didn’t have that ESG angle.”

In short, Smith surmised that the office should not be written off, and there are pockets of robust demand. “But you’ve got to be very selective in terms of flexibility, facilities, and ESG factors for additional appeal,” he reported. “In Europe generally, there is a shortage of modern stock under 10 years old, but new facilities or refits that improve those assets to offer what tenants want can result in healthy returns and an element of rental growth in those core markets.”

Specialist asset classes are in the target sights for investors of all types and data centres are a perfect example

Smith pointed to pockets of high demand for specialist asset types, with the firm being very active in those areas. “For example,” he reported, “there is a huge supply-demand imbalance for data centres, and this is a really interesting market, and data centres can be seen as a proxy for exposure to the changing world of technology. You need three key ingredients - proximity to population hubs, proximity to the fibre networks, and you need power, the last of which is in short supply in the European market. If you can buy an existing data centre asset, then there is a lot of intrinsic value in that. And we look at data centres from a real estate perspective, so we’re not taking operational risk. We look at assets on triple net leases so that the repair and maintenance risks and the obsolescence risk reside with the tenants and not the investor.”

He explained that these leases are typically 15 to 20 years or more, with an annual CPI uplift that is normally quite generous, in other words, with an inflation hedge built-in.

“The result is compared to logistics, which people see as the most comparable class, they trade at a 75 to 100 basis point premium, meaning they are very compelling from an investment perspective,” he reported.

Healthcare-related property assets are also front of mind during the pandemic and in high demand

Healthcare is front and centre of everyone’s attention these days, and so too for real estate investors. However, Smith reported that investors must be selective in terms of markets. Germany is a very good example, he explained, because of how healthcare is funded, particularly the care homes...
and the strength of the operators having secure covenants on a long-term lease, typically 20 to 25 years for new assets. And annual indexation is important, so too the funding for the occupants of the care homes, which is supported by the state. But he advised investors to look on a per country basis to determine which opportunities offer the most appeal.

**Affordable housing is another key segment, especially as residential real estate prices have surged out of many people’s reach across the globe and as ESG-centric investing increases**

Thornton also pointed to the need for a greater supply of affordable housing as one of the most important areas for society at large, but he noted it is also one of the most politically charged segments. He explained that there needs to be cross-sector work done amongst the politicians and the governments, and also to make sure public opinion is supportive. He reported that Principal sees the thesis and bought into a portfolio of affordable social housing assets in Ireland this year, from a platform specialising in buying up existing non-social housing stock, refurbishing it, and then making it available at a discounted rent to people who were on the local authority list, with support from those local authorities.

He explained that this investment was originally in response to the Irish government’s ‘Rebuilding Ireland’ housing policy, which promoted institutional investment in social housing assets as long-term secure income streams, but the investment was impacted by backlash from voters in Ireland against institutions buying up large developments, blocking voters from becoming owner-occupiers. The result was not what was anticipated at all, he said, and the powers that be then imposed a new and higher real estate transfer tax on any party buying portfolios of 10 or more residential properties in Ireland, including social housing. “I had hoped and expected to then bring the formula to the UK and elsewhere, because I thought it was a really good way of creating quality stock and making it available at affordable rents, but it highlighted the risk of political interference in this space.”

He also remarked that other countries have different environments, and they are not entirely dispirited or put off the sector. For example, Spain has a specific use class for affordable housing, virtually a rent to own model where half of people’s rents were allocated over 10 years to a deposit so that they could then buy those houses when they had a better credit history and some cash in the bank.

“We want to be involved because we have to make this segment work as an industry,” he concluded. “It might be a big challenge for us, but it’s a big opportunity for us to do our bit for society.” However, he said they would only proceed if the overall attributes are favourable.

**Impact investing in the real estate sector and balancing the S in ESG with the need for returns**

Smith agreed and noted that the impact type investments in real estate are of appeal to many of the group clients. “But they really are grappling with the right strategy,” he reported. “Most of them are
looking at the effective trade-off between that social benefit and the financial return. So, we are continuing to engage with our investors on these areas. While the E in ESG has been most people’s core focus, the S in ESG is certainly moving up the list of priorities for many investors.”

Thornton commented that while the founder generations of many wealthy families tend to see return as vital, before the mission to do good, the younger generations are willing to sacrifice returns for making more positive impact. “We are hearing that for some of the generations coming through [in these very wealthy family offices], doing good for the sake of doing good is becoming perhaps more prevalent,” he reported.

Where the US goes, the UK and then Europe tend to follow, but Europe has some specific idiosyncratic qualities that also appeal to investors

Thornton observed that whilst we are seeing anything other than a normal path of the US bouncing back first and then the UK, then Europe. “The US has really done well in the past 12 months, but Europe has lagged as usual,” he explained. “At the moment we have something over 200 basis points spread in interest rates between the US and Europe, so if you are structuring a leveraged investment, the cost of debt is significantly cheaper in Europe, actually somewhere around about 1% for 50% LTV depending on which market you’re in and the type of asset.”

The second key factor centres on supply constraints. “The US, when it recovers, tends to bring a lot of construction, rather like Asia, and therefore quite rapid depreciation in older building stock,” he noted. “In Europe, you tend to see much less depreciation, much more value inherent in the land, in certain of the asset classes. And also, if you’re putting a CIO hat on and you’re looking at the benefit of real assets into a portfolio, you tend to find that the diversification benefits of European real estate are much stronger than those of US real estate and obviously much stronger than those of equities and public market securities.”

He concluded that these are additional reasons for investors to buy into a fund. “In the current environment, it is challenging to see the real estate, to see the manager, so, we are seeing people such as family offices, initially using commingled vehicles rather than buying individual assets,” he reported. “Clearly, the desire to own your own individual asset remains strong, so we have seen both approaches.” He added that they have also seen investor interest most robust in very clear thematic investments, such as data centres, where you can gain broad approval and the logic is clear to anyone involved.

Matching the right opportunities with the right clients is vital to the Principal proposition

Smith added that knowing their clients is vital to their proposition. “We need to know what returns they expect, the trade-off they anticipate between income or total return, their risk appetite, their holding power, their expectations around liquidity, and then we can tailor different opportunities to them, in other words, assets that really fit their needs and expectations.”

He emphasised the importance of liquidity in what is a typically illiquid asset class. “It takes time to create liquidity, if that’s required,” he remarked. “So, we have our open-ended entities, and we also structure segregated accounts with very bespoke strategies for our clients on specific themes or focusing on certain risk profiles. But the big picture is that we focus on understanding what’s required, and matching those investor needs to the underlying real estate investments.”

Smith’s final word was that the European real estate market is continuing to evolve rapidly, but that if approached carefully and logically, the market in Europe has a lot to offer investors seeking diversity and longer-term sustainable returns.
A SHORT NOTE ON PRINCIPAL REAL ESTATE INVESTORS

FROM THE PRINCIPAL WEBSITE

“Principal Real Estate Investors is the dedicated real estate investment group within Principal Global Investors. We build on a vertically integrated platform that incorporates all disciplines of commercial real estate. By providing access to opportunities across the spectrum of public and private equity and debt investments, our clients are able to customize their real estate portfolios to their specific objectives, including sustainability and risk management guidelines.”

Specialised expertise across four real estate quadrants
Our capabilities are backed by more than 60 years of real estate investment experience, when we started as part of the real estate investment department of Principal Life Insurance Company.

Since then, we’ve built a top-tier investment platform that provides comprehensive, specialized capabilities across all four quadrants of commercial real estate—public equity, private equity, public debt, and private debt. This platform gives us a unique perspective on real estate space and capital markets, allowing us to deliver solutions that meet your investment goals.

OUR PLATFORM OFFERS:
Broad market access
Our diverse investment teams, located in the U.S., Europe, Asia, and Australia, have deep relationships within the industry, giving us preferred access to commercial real estate investment opportunities. This broad access also contributes to our research, allowing us to continuously incorporate real-time data and information into our underwriting and investment decisions.

Research-based investing
Our investment process is team-oriented, multi-disciplined, and research-based. Research is fundamental to our ability to assess relative value both within and across quadrants, and to deliver on your investment goals. The foundation for our investment decisions is a combination of top-down economic and sector analysis with bottom-up asset analysis, providing our investment professionals with the insights they need to successfully execute strategies.

Consistent, risk-adjusted performance
Our goal is to deliver consistent, risk-adjusted performance and superior service. Our market reach and research are vital to achieving this goal—and so is our commitment to innovation, whether it be sustainable investing or the “next generation” investment strategy or solution.”

NOTE FOR HUBBIS READERS:
For further understanding of Principal Real Estate Investors and their insights into different market segments and trends, please refer to these recent papers the firm has released:

» Data centre bulletin compendium | www.principalglobal.com | Principal Real Estate Investors

» Special report: Europe’s return to the office will be robust but uneven | www.principalglobal.com | Principal Real Estate Investors

» European Core investing: Looking beyond the pandemic | www.principalglobal.com | Principal Real Estate Investors