

Mixed views



*How are managers
responding to the challenge
of pandemic cycle investing?*

by James Wallace

Before the COVID-19 crisis, investment markets were already in a complex state. On balance, much of the complexity — from unravelling the global financial crisis (GFC) to the twin drivers of subdued global economic growth and low inflation — were net positive for real estate investment. The sector has been a massive beneficiary of global central bank monetary policies that have artificially suppressed interest rates and inflated asset prices through trillions in “printed” money.

After four months of forced economic hibernation, societal lockdowns, staggered reopenings and pandemic relapses, the environment is now even more convoluted. Increased uncertainty may yet prompt asset allocators to re-evaluate some long-held propositions that have supported investment decisions throughout the post-GFC period. Near- and medium-term strategies will be influenced by markets, sectors and strategy type, overlaid by the perceived balance of all uncertainties and outcome probabilities.

The accepted wisdom suggests that COVID-19 has accelerated pre-existing structural real estate demand drivers: hastening the decline in some sectors (retail, leisure); testing the resilience in others (offices, co-working, student accommodation); and strengthening the fundamentals of a select few (industrial, data centres).

But this is an arguably oversimplified picture. Even the optimistic outlooks for the so far most resilient sectors have downside risks. For illustrative purposes, consider a scenario in which economies are forced into periodic lockdowns and where progress in vaccine development and its global distribution is slow. Under such circumstances, any surge in ecommerce, as experienced during the first lockdown, may be more subdued as households and businesses hoard cash in anticipation of a deep recession. This entirely conceivable situation illustrates how quickly even resilient sector performance can unwind in these radically uncertain times.

A more judicious perspective might be that wide variance remains across interrelated variables: public health, the effectiveness of government and central bank measures, household and business spending, and broader economic revivals. Together, the balance of outcomes across these intertwined drivers can influence a wide range of sector outlooks, shaping strategies accordingly.

In short, although a degree of coalescence in sector and strategy expectations has formed, a great deal of uncertainty remains, leaving commentators split on real estate’s medium- to long-term fortunes.

Contrasting views

Tony Smedley, head of Heitman’s private equity business in Europe, says retail and industrial dynamics have been fundamentally reinforced. “We view the long-term effects of COVID-19 to be positive, overall, for the industrial and logistics sector. The pandemic will likely accelerate trends toward ecommerce, fueling long-term logistics demand. Disrupted supply chains may encourage ‘near-shoring’ — driving demand further. Long-term investment and pricing will remain robust.”

In contrast, Xavier Jongen, managing director at Catella Investment Management Benelux, says the sharp rise in logistics demand may be temporary, rather than setting a new base demand for ecommerce. Similarly, he predicts that the co-working market will experience a short-term shake-up, but ultimately, many providers positioned in the right areas could benefit. “Price rises are on the cards for properties in triple-A locations should there be increased liquidity,” he says. The residential sector is also one to look out for, in Jongen’s view. “[It] stands out for offering stable, long-term income, now and in the future, and we also expect residential properties to become more attractive as a hedge against inflation.”

The crisis has reaffirmed the resilience and long-term growth potential of the speciality sectors — private rented sector (PRS), student, senior, and self-storage, suggests Heitman’s Smedley. “Structural drivers in those sectors are also unaffected or supported by the pandemic, given their reliance on demographics, and low penetration rates. For example, there is no evidence of a shift out of cities by renters, but potentially more movement within them if demand for garden and home office space increases.”

Heitman’s optimism on the long-term prospects for student accommodation has been tempered with the concession that international student demand in the short term “needs to be managed”. While population growth among 15- to 19-year-olds throughout Europe, and other relevant parts of the world, continues, future demand for campus-based student learning could be stifled in the coming academic year, which may entrench behavioural shifts in higher education. Rob Mathias, partner and head of international at Harrison Street, says the short-term challenges facing the European student accommodation market include universities reviewing long-term campus housing needs.



“We are working with some of our university partners who are seeking to ‘de-densify’ their on-campus configurations by utilising additional off-campus facilities, many which have bed-bath parity, to limit the number of students in shared living spaces,” says Mathias. Long term, Harrison Street remains bullish: “We believe the asset class has strong, long-term fundamentals as well as an operating model that has proven to be flexible, adaptable and resilient.”

It is office demand, however, that most alludes a consensus view. “Time is now needed to assess the impact on occupier footprint as firms increase adoption of remote working,” says Smedley. “Tech firms were the main driver of office take-up in the previous five years — they are now expected to be strong adopters of WFH [work from home]. Even the financial sector is doing the same. For example, big banks are actively downsizing and looking to reduce the footprint in central London.” In late July, RBS told about 50,000 staff that they will continue to work from home until at least 2021, which echoes similar positions by several global investment banks, including JPMorgan, Morgan Stanley and Barclays, whose CEOs have all indicated their long-term city office demand requirements are up for review. “Supply risk now needs to be scrutinised much more closely, as downsizing firms leave behind vacant space,” adds Smedley.

Richard Buytendijk, senior research and analytics manager at INREV, says: “Changing working habits and preferences means there is more caution from investors about when and where they should allocate capital to the office sector. There is some way to go before we see any real clarity around future investment trends for this sector.”

Core vs opportunistic

As things stand, investment strategies for the specialty sectors have required less adaption during the crisis, with many managers claiming that no alterations in focus have been necessary.

“Our managers’ strategies and operations have not changed,” says Randy Caenen, an executive board member at Nedlloyd Pensioenfonds (NPF), the Dutch pension fund manager. “Actually, I am glad they didn’t, given that we expect them not to drift away from what they are supposed to be doing. The managers have proven capable of reporting and updating us on developments. However, the impact on valuations is still uncertain. We will pursue financial returns at a fair cost, but we also want to see our investments being purposeful for the challenges the world is facing.”

The picture for mainstream real estate, however, may be different. Peter Hobbs, the managing director of private markets at bfinance, notes the striking parallels between the early-stage investment performance of core, value-added and opportunistic funds during the GFC and the COVID-19 pandemic. He explains: “There are many concerns over the prospects for core real estate, with several open-ended funds in Canada, the United States, the UK, and continental Europe suspending their redemptions due to material uncertainty over their valuations. At the same time, many value-added and opportunistic managers are talking up the opportunities that are likely to arise over the coming quarters.

“As with [the period following] the GFC, the coming two years are likely to be good vintages for investing, but value-added and opportunistic assets acquired over the past three years are likely to suffer



In June, Nuveen Real Estate acquired a newly developed 25,000-square-metre (269,000-square-foot) industrial asset from VolkerWessels Logistics Development. The property is located in Apeldoorn, the Netherlands, at the heart of the A1 ‘logistics corridor’. The asset will become the new headquarters for Welkoop, the Dutch retailer. Opinions are split on how the COVID-19 crisis will shape the future of logistics.

far more significantly than core assets acquired over the same time period.”

“I am curious about how forceful and impactful the strategies will be,” says NPF’s Caenen. “I would expect that investors and managers will focus more on value-add and opportunistic projects as they can deliver what the world needs in terms of sustainability. Sticking to core and core-plus will not push the needle in the right direction, but rather will maintain the status quo. To put it differently, sticking to safe assets could be very risky for society. Still, this is hope I am expressing, I am not sure how far managers are in determining the needs of the investors and the environment and how brave they are confronting and pursuing investors to follow them through.”

Hobbs stresses the enduring relevance of core and open-ended real estate investing institutional portfolios. “It is this real estate, where most of the return comes through income, that plays such a powerful role in multi-asset class portfolios, through the level and duration of the income it generates, through diversification to more liquid asset classes and its relatively attractive risk-adjusted returns. When most investors conduct their asset-liability modelling or strategic asset allocation exercises, it is this type of real estate that they want exposure to, not the more private- equity-style, higher-yielding strategies.”

Future disruption

The full impact of COVID-19 has yet to fully sink into the market, with price adjustments so far isolated to specific deals as much of the market remains paused, says Harrison Street’s Mathias. Real estate operators are focused on cash management, preserving liquidity, delaying capex plans, refinancing and seeking loan repayment holidays, as required.

“Real distress is yet to flow through to the market, with banks not yet testing valuations nor resetting covenants,” says Mathias. “However, market data suggests headline yields have been stable across our primary markets in Europe, with any deals that have completed in the last quarter seeing increased structuring, fee negotiations and small land price adjustments to provide for an additional risk premium to pre-COVID-19 levels — but without significant reductions in headline sales prices.”

A significant disruption in business travel has affected deal flow, and INREV’s Buytendijk sees this continuing for the foreseeable future, as it will still be hard for people to undertake physical and face-to-face visits, making it harder to build new business relationships. “Instead, some investors will be likely to rely more heavily on their existing local partners,” says Buytendijk. At the same time, there has been an increase in technology adoption, to support home-



A multi-tenanted 12,672-square-foot modern office building in Katowice, Poland, with 183 car parking spaces. The property has been bought by M7 Real Estate for the manager’s M7 CEREF II value-add opportunities fund. Many value-added and opportunistic managers are talking up the opportunities that are likely to arise over the coming quarters.

working during the lockdown, but also in longer-term workflow digitalisation investment.

“We expect a new wave of digitalisation to accelerate across real estate markets,” suggests Vishal Soni, co-founding partner at Oxane Partners, a technology platform for the alternative investment industry. “As investment firms prepare for a post-COVID-19 world, on-the-go and always-on access to data, systems and collaborative tools will become more mainstream to ensure smoother investment operations.”

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Catella’s Jongen suggests the pandemic will continue to affect the investment management community for another 24 months. Heitman’s Smedley argues that the shaky fiscal position of many European countries, coupled with the progress made in increasing health system capacity, means that future lockdown measures may not be as stringent as those experienced in April and May, making it easier to begin assigning large amounts of capital.

“Where investors a mere six months ago only wanted to be shown funds with some existing assets, today they are seeking new vehicles with fresh dry powder to exploit anticipated dislocations to come,” says Smedley. ❖

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