UBS Asset Management

Real estate strategies in a changing monetary and disruptive economic environment

Over the last three decades, bond yields have kept on a steady contractionary path following more or less in line with falling inflation. European real estate prime yields have showed a similar pattern, at least since the late 1990s, albeit with a short interruption during the Global Financial Crisis (GFC). In particular since the introduction of "extraordinary" policies by Central Banks, bond and real estate yields have contracted significantly. Inward yield shift has given real estate capital values a rising tide, even at times when real estate market fundamentals were weak and rents were falling. Following Central Banks' minutes and speeches, the monetary policy–injected capital tides have been changing — or, in the case of the European Central Bank (ECB), are likely to change. Markets are expecting that the ECB is announcing a termination of its "Asset Purchase Program" (APP) in September 2018. Despite all the remaining political uncertainties, Eurozone bond yields have been rising since their trough point in third quarter 2016.

In the still-low bond and real estate yield environment, it might be appealing for investors to move up the risk curve by investing in less core locations, taking more leasing risk or investing in "emerging" real estate segments. However, investors should consider that the change in monetary policy comes at a time when the real estate industry is facing challenges from disruptive elements. Even though many believe that technology is a disruptive force, actually technology is just an enabler for changing business needs, consumer preferences and lifestyle choices. As a real asset, real estate has always just been the shell for companies to do their business and for people to live their lives (and lifestyles). The reason the real estate industry and investors do consider the recent developments as disruptive might be that the way businesses operate and how people live has been broadly unchanged for decades. But this does not mean that this will continue. Technology enables corporates to implement new setups and people to follow different lifestyles. The combination of both leads to a changing society, and the question arises: how should real estate investors adjust their strategies in times of change or transition? Shall investors move away from core strategies and go up in risk?

Definition of core real estate gets challenged

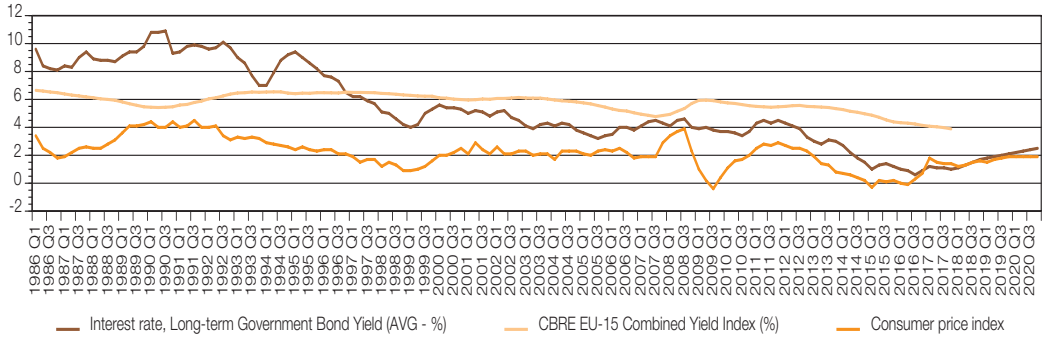
We recommend that real estate managers and investors alike should change their perception on core. Until now, core has been defined more or less as the duration of the income and the governance of the lease. The definition of core is likely to move more in to the direction of an asset's re-lease-ability, determined by its connectivity and adaptability. Disruptive challenges in the retail sector are more advanced and acknowledged in the real estate industry, while in the office sector, we might be just at the beginning. Location is likely to become even more important than in the past. However, the definition of location and accessibility also needs to be revisited.

Disruption in the occupier's business is likely to change the definition of core real estate.

Historically, most European cities followed the concept of separating working and living geographically. Central Business Districts (CBD) in Europe are mostly defined by public transport accessibility to the living areas. Even though CBD locations are likely to stay relevant, technology might enable people working closer to home, and new working locations may arise. In retail, convenience and entertainment are likely to be dominant factors for the success of physical outlets. Logistics has become a new physical outlet for e-retailers and omni-channel retailers. E-retailing is highly competitive and consumers' expectations on delivery services are increasing massively. Furthermore, logistics is very capital intensive — thus expensive. Consequently, logistic facilities have to move closer to the delivery point, which means that logistic sites compete increasingly with other land uses in urban areas, mainly residential.

Business cycles are getting shorter. Most business plans have a projection for the next three years — some, five years. As a consequence, businesses are less likely to accept long leases. The recent success of co-working space could be partly explained by landlords' inflexibility and a shortage of office

Reversal of monetary policy will gradually put outward pressure on property yields



Sources: Oxford Economics, 21.3.2018, CBRE 4Q 2017. 2018 Q3-2020 are forecasts

Please note that past performance is not a guide to the future.

supply. Investors should take on this challenge and adopt a more active management strategy. However, this also requires improving due diligence practices, in particular in assessing the location and adoptability of the asset, but also investing in technology to manage the asset. Investors' traditionally most preferred sector — offices — are likely to become more like retail or even like operational real estate, such as hotels.

Today's constrained office supply situation in CBD locations and low yields are pushing investors to more secondary or even peripheral locations. However, moving up the risk curve geographically might be short-lived success. Nonintegrated suburban business parks may see rental growth in the short term, but "disruptive" changes in the business environment may hurt these locations particularly hard in the long run.

Opportunities in a disruptive environment

REPM's Eurozone real estate market forecast expects a total return for all property between 2018 and 2022 of 4.9 percent annually, with an annualised capital return of just 0.4 percent. The potential tidal change by the expected more restrictive monetary policy is likely to limit capital appreciation strategies and favour capital preservation strategies, focusing mainly on income and income growth.

Normalisation in the ECB's monetary policy may not only lead to rising bond yields but also to increasing spreads between countries. Currently, prime real estate yields are at historic low levels, and any small change in yields requires decent rental growth to compensate the capital loss by outward yield shift. Even though office development activity across Europe is still muted, we think that rental growth rates in the prime segment are likely to slow and may not compensate the loss in capital values by outward yield shift over the next five years. Today's higher yielding locations and assets should be carefully assessed on their future rental growth prospects; otherwise these assets could be heavily exposed to the expected changes in monetary policy. Therefore, we believe that compromising on location in a rising bond yield environment is not advisable.

Income-growth strategies are supported by Eurozone's positive economic and business outlook. The Eurozone economy is forecasted to grow at a rate of more than 1.5 percent over the next five years, with significant variations between countries. Furthermore, Eurozone's companies' earnings growth rates are expected to increase, meaning that the

To be successful in this fast-changing environment, accept the challenge and create the future!

Eurozone companies are likely to expand further, providing a supportive environment especially for the core office sector. However, considering the disruptive elements in the occupiers' businesses, we believe that active management properties, offices and retail alike, in core locations are likely to be the defensive core income-growth strategy in this fast-changing tenant environment, at times with more expected headwinds from monetary policy. This "management to stay core" strategy offers the opportunity for rental/income growth to compensate for pressure on capital values by expected outward yield shifts. Geographical diversification is likely to stay important because economic growth rates are likely to vary between Eurozone countries. We also recommend diversifying the income stream by adding new real estate segments to the portfolio. Demographics are the most predictable mega trend. Residential segments like multifamily, student housing and medical centres are still in many European markets' niche segments, but they offer the opportunity to diversify a core income stream. Adding urban logistics can also be considered as defensive, as the areas offer high residual land value and could be converted to other land uses such as residential. Furthermore, incorporating ESG (Environment, Social and Governance) in a core strategy will become crucial not only to attract investors' capital, but also tenants.

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Gunnar Herm, an executive director, is primarily responsible for developing and delivering proprietary research products for use in analysing risk and return for various European real estate investment opportunities. He also develops fund strategies, helps develop new products and supports ongoing capital-raising efforts.

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CORPORATE OVERVIEW

UBS Asset Management

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