UBS Asset Management

Core real estate in a disruptive environment

Gunnar Herm
Head of Real Estate Research and Strategy – Europe
UBS Asset Management

Gunnar Herm, an executive director, is primarily responsible for developing and delivering proprietary research products for use in analyzing risk and return for various European real estate investment opportunities. He also develops fund strategies, helps develop new products, and supports ongoing marketing and capital-raising efforts. He is a member of the European Investment Committee and a guest member of the European Product Board of Real Estate. He has also chaired the European Investment Strategy Committee since 2010. Herm joined UBS Asset Management in 2006.

Some people refer to the current market environment as disruptive. Would you agree?

Challenges only become disruptive if investors neglect change for too long. The key is to accept the challenge without getting disrupted. The environment for managing core real estate has been pretty constant for at least two generations. Current developments are leading to investment opportunities in core real estate strategies that are more actively managed. Over the past decade, core real estate strategies have been based on offering leasing space according to local market practices, which have been, in many cases, landlord friendly. Structural changes in our society and the economy, together with technological developments, have started challenging these local market practices. Traditional real estate mindsets may see this as disruptive, but forward-looking actors may take this as a challenge, which creates opportunities in a changing core real estate environment.

Do you see the changes as unique to this time?

Yes and no. Over the last 10 years, the environment for real estate owners has changed rapidly due to changes in how businesses operate, in consumer behaviour and lifestyle. As a result, social perceptions have influenced government regulations, corporate asset-use policies and individual lifestyle choices. Demographic changes have increased, and technological advances have facilitated these developments. All real estate sectors are likely to be influenced by these structural changes. Existing core real estate strategies will also be challenged, and current business models may be disrupted. Core real estate strategies are designed for longer holding periods, which need to anticipate long-term themes but also need to consider the current market environment and dynamics. Change only becomes disruptive if investors do not accept the challenges. This has been a period of transforming the economy from manufacturing into a services-driven economy (the rise of offices), new forms of distributing goods to the end consumer supported by cars (the rise of shopping centres and retail warehouses), and increasing urbanisation (the rise of multifamily housing).

You mentioned offices and the service-driven economy. What are some of the long-term impacts of this development?

For one, shorter business cycles require more flexible leases, which support serviced offices. Second, advances in technology make working remotely much more prevalent. And finally, millennials have shown a preference for urban living and working rather than suburban housing and offices.

In 2010, the first WeWork office opened its doors in the Soho district of Manhattan, equipped with residential furniture, incandescent lighting, exposed brick walls and iron pillars. It offered what was, at the time, a new concept for the working environment. Fast forward eight years, and the company is now the world's largest private occupier of office space — operating out of 253 locations in 22 countries. This is an example of the structural changes that have taken place and supported the rapid expansion of this particular business model — from virtually zero to a significant component of demand in many global office markets. This all centres on an increased desire and, in some cases, need for both corporate and employee flexibility.

In the very first WeWork office, the selection of tenants was far more aligned with typical perceptions of a co-working environment. Individuals or very small businesses from creative industries were sharing facilities for efficiency and to improve collaboration. But as the demand for flexible and creative working environments became more engrained in corporate culture, growth shifted towards the serviced office model, where companies rent out private office space on a flexible, short-term basis. This segment of the market will have major implications for commercial real estate landlords, going forward.

Such as?

We have already observed a noticeable decline in lease lengths over the past decade. In Switzerland, a UBS study of institutional portfolios revealed that 38 percent of lease lengths signed in 2011 were for more than 10 years. By 2016, this had fallen to just 6.8 percent. Conversely, the proportion of zero- to five-year leases rose from 38.8 percent to 67.4 percent during the same time period. Back in the UK, the same study of leases also revealed that, when there was a lease break or expiry, office space was left vacant 65 percent of the time, with only 24 percent renewed and 11 percent let within a quarter. This was the highest ratio of vacated space of the three main sectors.

Could office become the new "retail", in terms of the impacts of the Internet and e-commerce?

We have started to draw parallels between the impact that e-commerce is having on the retail sector today and how changing working practices may affect offices over the next 10 years. As with retail, we're not saying that the physical office will be dead, but rather transformed to offer more of an experience than simply just a working environment. And as seen in the retail sector today, centrally-located core buildings are expected to perform well, as these are the hub locations that employees and clients can access. In addition, with lower space requirements, corporates can be more selective on location.

On the flip side, secondary locations, particularly those that have poor public transport connectivity, are likely to suffer disproportionately. Business parks that lack amenity space are expected to see a similar fate to that of secondary retail parks and shopping centres — which is ultimately obsolescence. But we do envisage a new type of workspace developing in and around suburban population hubs for staff who don't necessarily need to travel into the main CBD office every day, but who desire or require a more formal working environment than the home. These suburban hubs are likely to take the form of shared working environments, where corporates may take out memberships for their staff or provide their own hub workspaces.

What about other sectors? What do you think will happen in the alternatives sector?

Increasing professionalisation and consolidation are moving alternatives to the investible universe. Artificial intelligence is transforming operating models in alternatives, the agility of the population is driving hospitality, and ageing population is supporting increasing needs for care.

We will continue to see a blurring of lines between traditional and nontraditional real estate. Investor appetite for nontraditional real estate has been gaining pace for several years, and, although much of this interest has been focussed on the living sectors, there has also been a growing momentum behind more operational real estate opportunities, such as hotels and assisted living/care homes. This demand is set to continue, with the 2018 *CBRE Global Investor Intentions Survey* indicating that 67 percent of investors are now actively pursuing investments in alternatives. But as we consider how the market for nontraditional real estate may evolve over the next decade, it's important to try and understand what is driving the capital towards these sectors — specifically, whether there are grounds for a sustainable blurring of the lines between traditional and nontraditional real estate in investors' portfolios, or whether this is just typical late-cycle behaviour.

Which do you think it is?

The decisions to drive capital toward new alternative sectors appear to be motivated more by underlying changes in demand than typical late-cycle behaviour, which would be focussed on the higher initial yields. Structural changes really incorporate other trends cited, such as ageing populations, re-urbanisation and millennial trends — big underlying changes that are going to affect the way people live, work and, ultimately, require real estate. With many of these shifts seeming to support the underlying demand for operational real estate assets, the big question is whether investors are prepared to take on the operational risk of underlying business models to access nontraditional real estate markets. Historically, the operational risks involved have put off many core investors from entering into more alternative sectors. To enter into the more alternative sectors, you typically need local expertise and a thorough understanding of the industry. The real estate world is evolving, and the idea that landlords can simply sign a lease with an occupier and collect the income is very much a thing of the past.

All these changes will have an impact at the portfolio level. What do investors need to be thinking about in terms of how they put together and adjust a portfolio?

Current sector allocations of core strategies may look a lot different in the future. Trends can already be identified by looking at MSCI's European real estate sector allocation and Real Capital Analytics' (RCA) transactional database. The most obvious change is the declining allocation toward retail. Since 2005, the allocation to retail has declined from more than 34 percent to 25 percent. While the allocations to office and residential have declined slightly, they have increased significantly for hotels. RCA's transaction-based sector allocation reflects more current investor sector preferences. For offices, RCA's allocation is still looking relatively similar to MSCI's allocation. Allocation to retail, however, is likely to decline well below 20 percent, while industrial/logistics may make up more than 15 percent of a future core portfolio. Even though residential is regarded as an emerging sector in many major European real estate markets, the sector is likely to gain more investor attraction; however, it might be limited by a highly-regulated environment for multifamily in many European countries. Furthermore, other alternatives and the hotel sector are likely to be incorporated into future core strategies, even if managing increasing complexity would require scale.

What about strategy?

Well, until now, core portfolios have been rather static and could be described as buy-and-hold strategies with occasional adjustments. Structural changes on the occupational and business side are likely to have significant consequences on a core real estate portfolio. Real estate assets are likely to become more asset-management intensive, and core income streams may face increased volatility. On the upside, successful active management may identify new income streams by providing additional services to the tenant, which increase the asset's income stream and, thus, the property's valuation. Location is likely to become even more crucial. Building or managing to core will become an integral part of core real estate strategies. The future for core strategies is more likely to be buy-and-manage.

CORPORATE OVERVIEW

UBS Asset Management

UBS Asset Management's Real Estate & Private Markets (REPM) business actively manages over USD $100 billion globally and regionally within Asia Pacific, Europe and the United States, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk/return spectrum, ranging from core to value-add and opportunistic strategies. We offer both direct real estate and infrastructure equity and debt investments, or indirect exposure to leading real estate, infrastructure and private equity managers. Investors can access our diverse product range across open- and closed-ended private funds, investment trusts, listed funds, REITs and bespoke separately-managed accounts.

CORPORATE CONTACT

Eoin Bastible
Head of Business Development – EMEA ex CH
UBS Asset Management, Real Estate & Private Markets
5 Broadgate | London, EC2M 2QS United Kingdom
+44 (0) 20-7901 5000 | eoin.bastible@ubs.com
www.ubs.com