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REAL ESTATE

The smart value-added investor

When the market turned decidedly negative in early 2022, the strong value-added investment opportunity in the wake of the global financial crisis (GFC) came back to mind for many and inspired a number of real estate players to repeat that success. Substantial amounts of capital have since been raised, but very little of it has been invested to date.

The value-added playbook of the post-financial crisis era was to acquire properties below fundamental values from financially overstretched owners and leverage them with cheap debt. The recovering economy took care of vacancies, while rental growth resumed. Exiting to cash-rich core investors, historically low yields delivered very attractive returns. Arguably, the results were a reward for bold market entry rather than any particularly strong effort by the new owners in the holding period. That game is not working in the current downmarket.

The root cause of this market reset is different, hence the treatment will have to be different as well. The last two down markets (dot.com bust and GFC) were characterised by a mixture of financial market and occupier market stress, relieved by central banks lowering interest rates. This time round, conditions are the polar opposite, with substantially higher interest rates being the trigger and occupier markets remaining resilient.

Value-added investors will need a different set of tools fit for this new environment:

1. Financing: Debt is not the answer; rather, exploiting other investors' entanglement in debt they can no longer afford. Five- and 10-year swap rates have been hovering just above 3 percent for euros and just over 4 percent for sterling since autumn 2022, with the forward curve signalling little change to come for long-dated financing costs. Borrowers may wait in vain for central banks to bail them out in due course. Banks are under pressure to avoid the "extend and pretend" approach, which would risk clogging up the financial system for years. Existing lenders, including debt funds, seeking to avoid disruption, will welcome new capital coming in and take problems off their books. Taking advantage of that needs patience, strong relationships with lenders and creative solutions. Waiting for attractive assets at low prices being dumped on the open market will not be a sufficient strategy.

2. Out-of-favour sectors: With occupier markets remaining resilient across sectors, stressed assets to pick off will be concentrated in the office and retail sectors – but even there, it will be limited to specific asset types. For both sectors, large lot sizes will be a key predictor of restricted liquidity and, as a result, high transaction yields. That means primarily shopping centres in the retail space and secondary offices with significant environmental, social and governance (ESG) capital expenditure challenges in offices.

3. Alternatives: In all other sectors – logistics, residential and the key alternative markets (student housing, hotels, data centres, innovation offices and self-storage) – real estate is more likely to deliver continued rental growth even in a recession, rendering a stress-inducing rental-market fallout very unlikely. That does not mean they are out of scope for value-added return expectations. High growth means cap rates have to rise less to offer attractive returns. Turbulence will take different forms – for example, it may take on the shape of struggling subscale operators or poorly planned and timed development projects.

4. Development issues: Development is primed to play a key part in the market clean-up to come. At current financing rates and development costs – and with sticky land prices – many developers have been caught on the wrong foot and are unable to deliver their planned projects profitably. That will open opportunities for fresh capital to come to the rescue.

5. PE toolkit: Financial stress on the financial and legal structure of real estate investments and opportunities to aggregate assets, as well as consolidate operations, hint at a blurring line between real estate value-added and private equity strategies. Bolstering returns through restructuring rather than plain real estate acquisitions may create a niche of private equity–type deals with a real estate flavour.

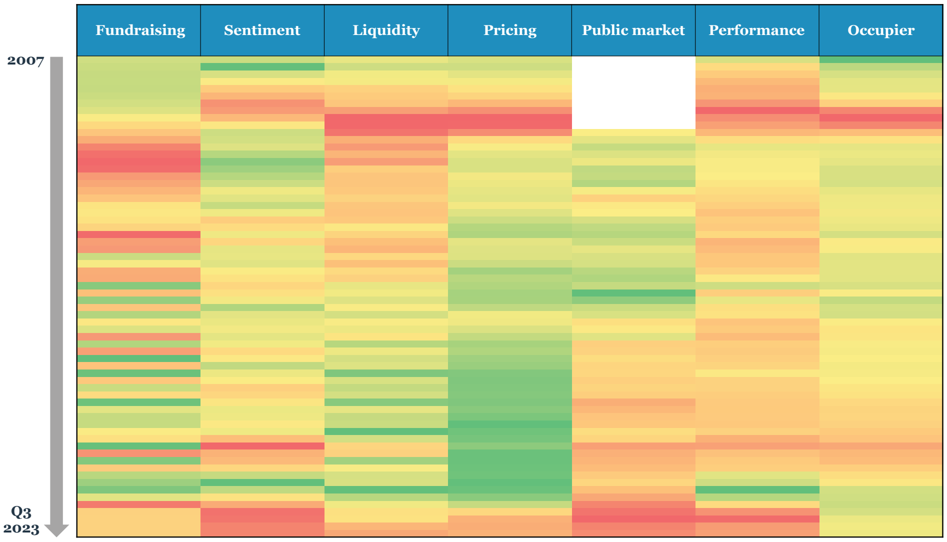
6. ESG: Net-zero carbon is the standout risk, as well as the top opportunity of this decade. Asset owners who still hold buildings that are complex and expensive to return to a greener path will fall prey to leaders in that space. Investors who have the technical capability, as well as the foresight, to target the right measures at the right time in the most promising property type and jurisdiction will have the opportunity to reap outperformance.

7. Asset management: If debt-fuelled market uplifts do not deliver returns without effort, investors who are prepared to get their hands dirty will have an edge. Sector specialism and local-market knowledge, combined with hard-graft asset management, will deliver returns the old-fashioned way.

8. Obsolete assets: Market resets expose underlying weaknesses, which had been propped up by buoyant cycles. These market segments and individual assets should have been flushed out, but they were kept afloat by overall market optimism lifting all boats and, most crucially, cheap capital. A whole generation of offices in Frankfurt, Stockholm and Amsterdam were swept away by the dot.com bust. Swathes of secondary stock in Southern and Eastern Europe never recovered from the euro-zone crisis, and a host of weak retail and leisure assets were ended by COVID-19. Dead-end assets ready for redevelopment and under new ownership will be plentiful in areas such as: low-building quality logistics, outdated office accommodation, low foot-traffic retail, residential in compromised locations, outdated leisure assets and unattractive senior-living estates. Would-be investors will have to think carefully whether these assets are cheap and full of potential or beyond rescue at any price.

The turbulence as financial markets rely on cheap debt has been exposed and will create winners and losers and plenty of opportunity for conviction investors, as long as they are not shying away from complex workouts. A simple buy-low-sell-high approach will not cut it in this environment.

How did the real estate market evolve over cycles?



Source: Nuveen Real Estate

The Nuveen Real Estate market health matrix:

The matrix groups more than 20 indicators into seven themes relevant for real estate market health. **Fundraising** looks at dry powder available to invest in private real estate and **liquidity** measures the actual volumes being traded. **Sentiment** shows investors' views on the market, while the discounts/premiums on **public markets** are used as a measure of the financial market's view on real estate. **Pricing** measures relative value of private real estate versus other investment sectors. Real estate **performance** reflects returns achieved in real estate and **occupier** gauges the underlying health of tenants and the space demand-supply balance.

Each colour represents one sextile of historical distribution (normalised data):

Very low, Low, Lower medium, Medium, High, Very high, No data available

The question remains as to why this process has not started yet. By summer 2023, distressed sales remain near historical lows. Additionally, market yields look like they are getting closer to plateauing, while rental growth slowed somewhat in many sectors but has not gone into reverse; even offices report continued rental increases.

There are good reasons to believe this is a false dawn. The key is held by the lending sector: Real estate does not have an issue with fundamentals but with finance. Regulation brought in after the GFC made it much less attractive for lenders to try sitting out breaches. Low-cost loans from the years prior to 2021 will only slowly reappear for refinancing, where borrowers will be exposed to the hard reality of higher financing costs and lower leverage. It will also start to dawn on distressed borrowers that hanging on a little longer will not save them, as the forward curve points to falling short-term interest rates, but indicates that longer-dated debt will not become any more affordable in the foreseeable future.

A variety of metrics analysed by Nuveen Real Estate further support this view:

- Bid-ask spreads remain high, suggesting up to another 30 percent decline in property values for some jurisdictions and sectors.
- Debt cost implies market-clearing yields are in the range of 20 basis points to 200 basis points above current levels.
- Risk premiums for European real estate are approximately 100 basis points, significantly below long-run averages of 200 basis points to 300 basis points.
- The net-zero carbon challenge is far from factoring in all the real costs, which range from 5 percent of values, even for the best assets, and can go up to 50 percent for low per-square-metre-value outdated properties.
- Forecasters have flip-flopped on recession concerns, stoking further market uncertainty. It still is far more than a tail risk that Europe will fall into a period of negative growth. That would challenge the occupier market resilience we have seen so far and may set in motion a more normal market downturn producing a larger number of motivated sellers.

The approaching refinancing reckoning is unlikely to cause an all-encompassing real estate market slump, as occupier markets and the economy are structurally too resilient for that, but for many market participants, the deck is about to be reshuffled. Value-added investors will have the opportunity to play a key part in building new market foundations.

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COMPANY PROFILE

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*Includes more than 385 real estate investment professionals, supported by a further 430-plus Nuveen employees. Source: Nuveen, 30 June 2023 GAR-3188548PF-E1023X