Zurich Real Estate Investments
Group Investment Management
February 2024

Real Estate Outlook 2024

Ten trends shaping real estate investor and occupier attitudes

For **Zurich Real Estate Investment’s 2024 Outlook**, we focus on ten key trends shaping real estate investor and occupier attitudes over the coming year and beyond. The ten themes span geographies, ranging from the macro, like climate and capital markets, to more micro, such as how rising insurance premiums may impact returns. We zoom in on evolving real estate sector trends and explore the case for vertical farming. We also speculate on the role AI will have on the asset class and learn from a few recent high profile real estate company failures. We conclude with our preferred investment strategies and how these may tilt in 2024. Enjoy the read, and of course we welcome your feedback.

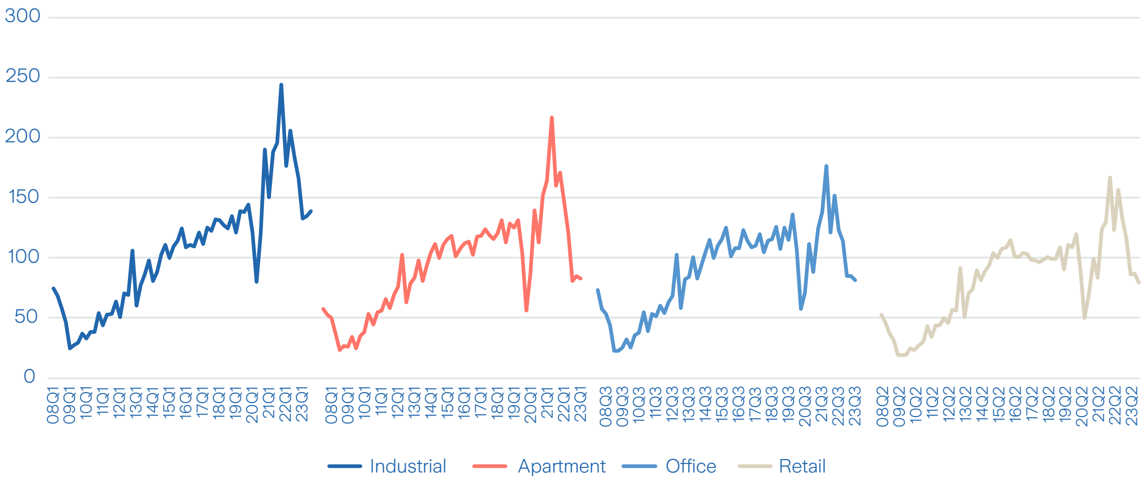
1. Real estate capital markets: moving to a state of acceptance

The onset of an aggressive interest rate tightening cycle in 2022 abruptly ended real estate's multi-decade bull run. The impact of this shift has yet to be fully reflected in private real estate valuations. While a lack of transactional evidence has provided valuers the rationale to be more measured with their marks, it has also given prospective buyers a reason for pause. Indeed, active participants in the market are fewer and less diverse (Figure 1), while buyer and seller pricing expectations are still at odds.

> If you are seeking to exit an investment, it is likely you will have to accept a higher cap rate than where you bought at. If that was in 2020 or 2021, it could be particularly painful.

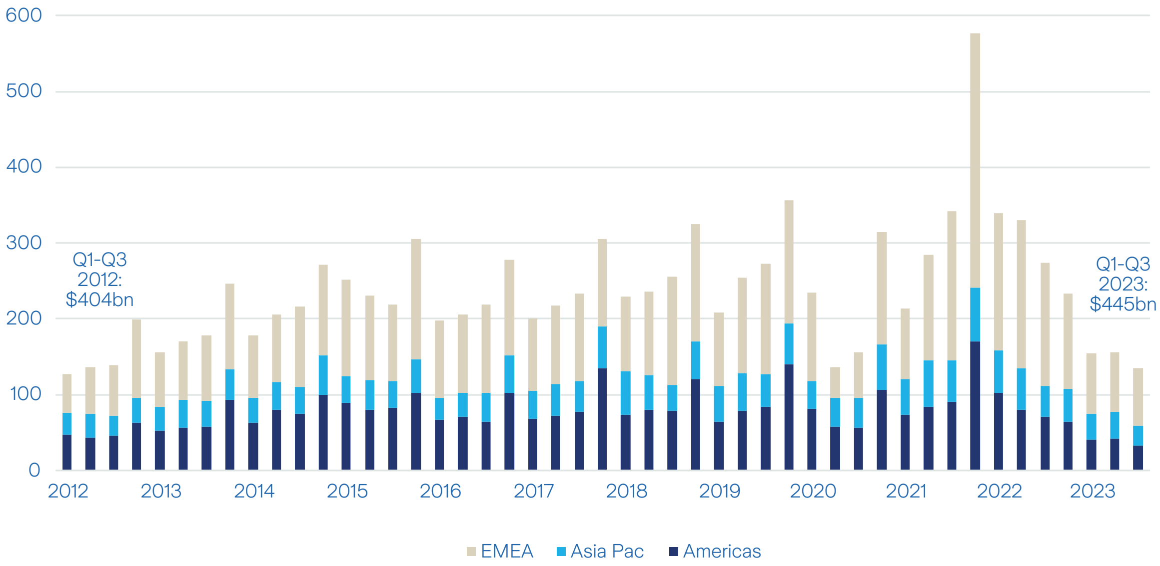
This reality has been difficult to stomach and has justified a cautious stance towards the asset class while translating to the lowest global investment activity in over a decade (Figure 2).

Figure 1: Unique monthly buyers by property sector in the U.S (2008-23), index, Q1 2015 = 100



Source: MSCI, Q3 2023

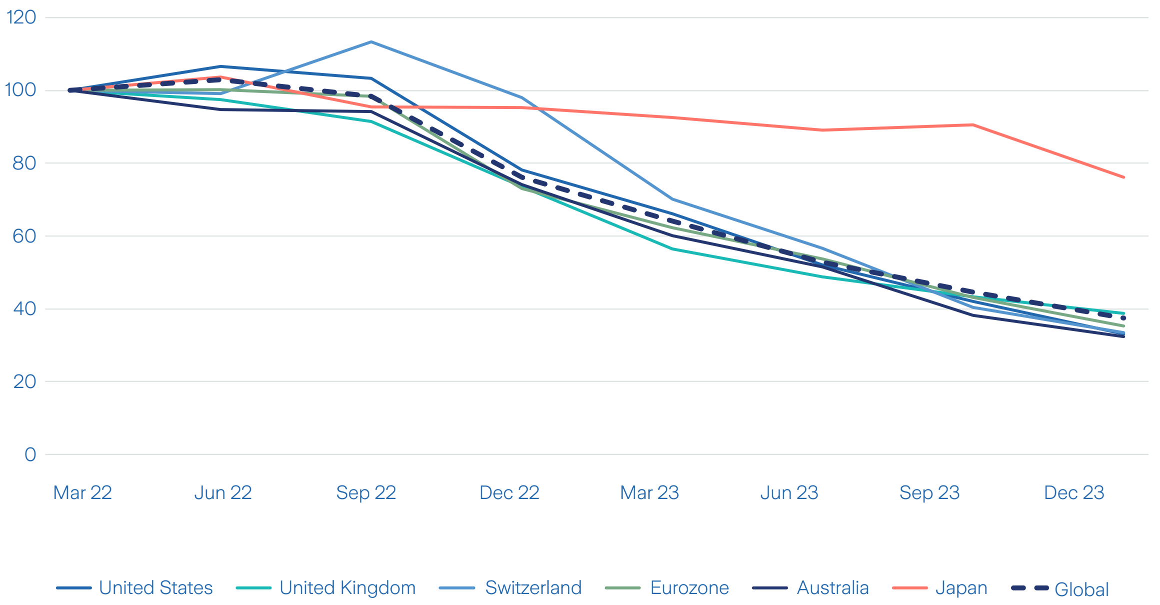
Figure 2: Global investment volumes, USDbn excluding development sites



Source: MSCI, Q3 2023

And the impact has been felt uniformly around the world, with only Japan suffering less given its different monetary policy approach (Figure 3).

Figure 3: Investment volumes, 12 months rolling, indexed to March 2022



Source: MSCI, Q3 2023

What will be the catalysts to unstick real estate capital markets over the coming quarters? Frankly the list of conditions is fairly easy to construct, though understandably, fraught in coming to fruition. From our perspective, this is what is required:

- Greater certainty around the path of inflation;
- Clear communication from central bankers on where terminal rates will land;
- Reduced bond market volitility;
- Easing credit conditions;
- And the avoidance of a jobs recession.

While all of these could transpire in 2024, it is far from a consensus call that they will in a synchronised manner. It's no wonder that our Market Strategy and Macroeconomics (MSME) team entitles its latest macro outlook, "**Skating on Thin Ice**." Frankly the risk that any one of these components reverses over the coming quarters, let alone multiple, is elevated.

The recent Fed dot plot underscores such uncertainty (Figure 4). This suggests a low likelihood of a widespread relief rally in transactional activity this year.

Figure 4: December 2023 Implied U.S. Federal Funds Target Rate (Dot Plot), %

Source: LSEG Workspace, Dec. 2023

But property markets are in a very different place than a year ago. Valuations have adjusted considerably already while investor attitudes are moving to a state of acceptance. This implies an eventual willingness by vendors to consider buyer offers, enabling more product to come to market. We see this being aided by fund lives drawing to a close, business plans being executed as well as refinancing obligations forcing decisions. On the back of this, capital raising should improve as investors acknowledge vintage opportunities. While volumes may be off the heady levels of the early 2020s, we see greater investor participation, ultimately contributing to healthier market dynamics this year.

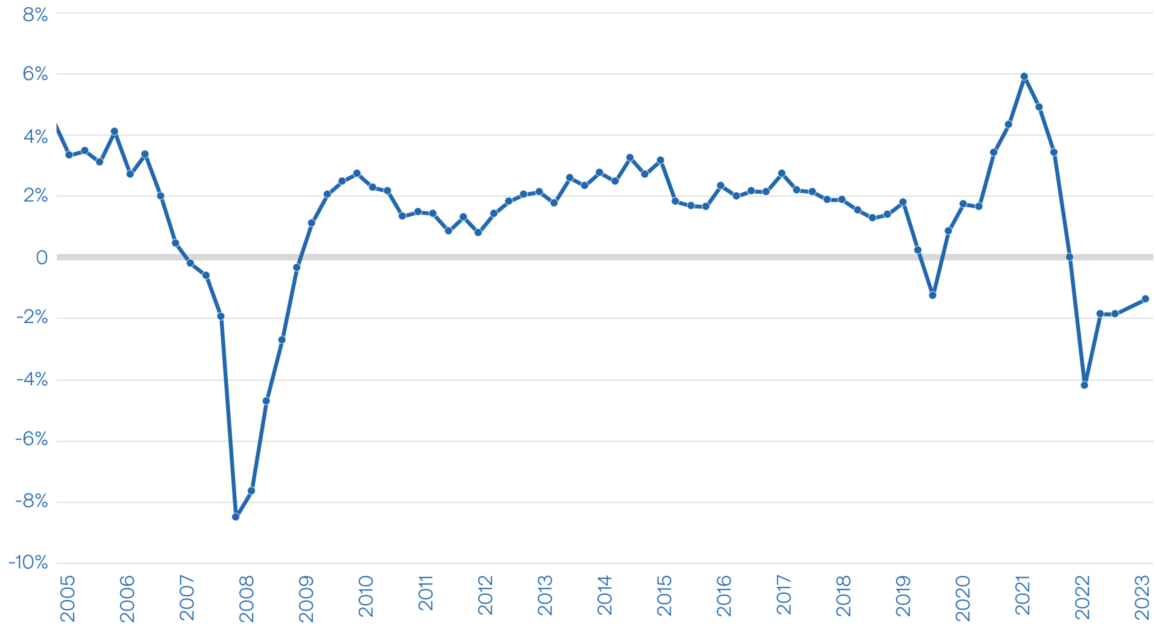
1. The Fed dot plot shows where each member of the Federal Open Market Committee (FOMC) thinks interest rates will be at the end of the next several years and over the longer run. The estimates are represented by dots arranged along a vertical scale — one dot for each of the FOMC members. Clusters mean a majority of Fed members agree about where interest rates might be in the future. Projections are updated quarterly and subject to change.1.

2. Income to take total returns into the black

So if transactional markets are set to begin normalising, what might this mean for performance prospects in 2024?

Global returns, as read by the Global Real Estate Funds Index (GREFI),[2] have been negative for five consecutive quarters through Q3 2023 (Figure 5). At cumulative -9%, this is the worst outturn since the GFC, when returns totalled -27% over eight quarters. While this correction is fundamentally different than the GFC in its origins and its impact on real estate, if we crudely take that major market correction as a template, then we could see negative global returns through the middle of this year. A market more advanced in its repricing, like the UK, will likely bounce back quicker, while the opposite might be said of Australia. As a guide, we see pressure on valuations for the first half of the year in the major markets where we operate, with income taking annual total returns into the black.

Figure 5: GREFI all funds index, total returns in local currency, %

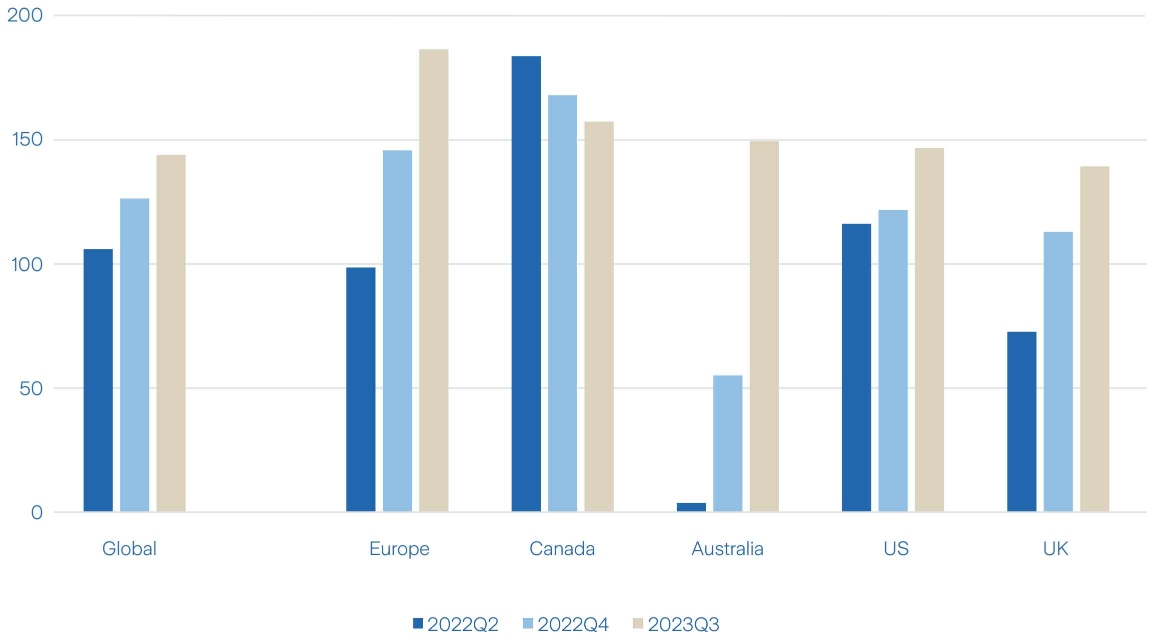


Source: Global Real Estate Fund Index, Q3 2023

2. The Global Real Estate Funds Index (GREFI) measures net asset value performance of non- listed real estate funds on a quarterly basis. Performance is measured net of fees and other costs and represents the aggregate investor return. It is comprised of 434 funds and represents a total GAV of USD 92 billion as of Q3 2023.

Private markets are regarded for having lower valuation volatility. Another way of saying this is that appraised valuations are smoothed and lag transacted prices. During periods of capital market disruption, like what we've recently seen, this disparity can be rather pronounced (Figure 6). But the valuation lag is felt on the other side as well. The improved transactional evidence we anticipate in 2024, even with distressed sales appropriately caveated, may not flatter portfolio valuations when they come due.

Figure 6: Spread between transacted and appraised property yields

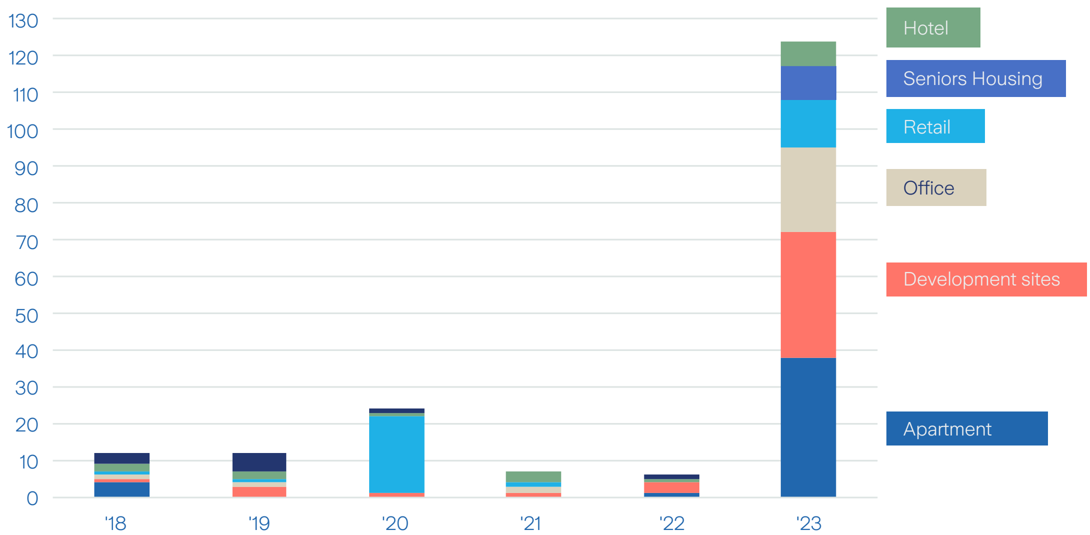


Source: MSCI, Q3 2023

And what about distress? According to Real Capital Analytics, forced sales in the first three quarters of 2023 were substantially below GFC levels, but there are pockets of distress emerging. The office sector in the US is a growing concern, particularly San Francisco, Los Angeles and New York. In Europe, Germany warrants attention as values have fallen sharply and it's economy sputters (Figure 7). In APAC, so far distress appears to be limited to China, while key developed markets have shown resilience. Japan's accommodative monetary policy has acted as a buffer. A delayed adjustment in valuations in Australia suggests that 2024 may be more challenging.

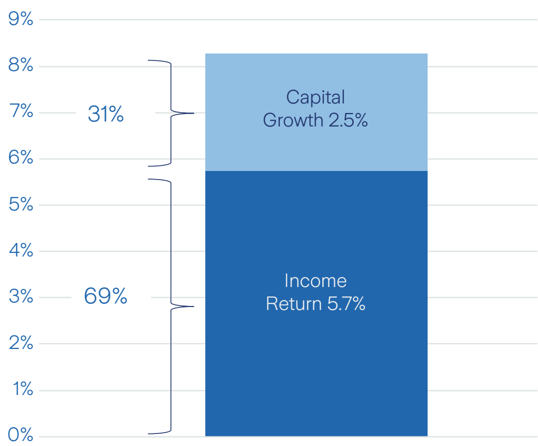
As we'll explore in the real estate sector chapters, occupational conditions are reasonably healthy. And this is a reason to be optimistic about real estate performance prospects over the coming year. NOI growth has generally been healthy around the world, even with recessionary risks and sectoral disruption. The ongoing adjustment in values has been almost exclusively a consequence of deteriorating capital market conditions. As these begin to ameliorate, income will boost returns higher. And after all, over the longer run, it is income that composes the majority of real estate's return (Figure 8).

Figure 7: Count of German Properties in Distress



Source: MSCI, Q3 2023

Figure 8: MSCI UK Annual Index total return components, 1980-2022, %



Source: MSCI

3. Logistics: still attractive after all these years

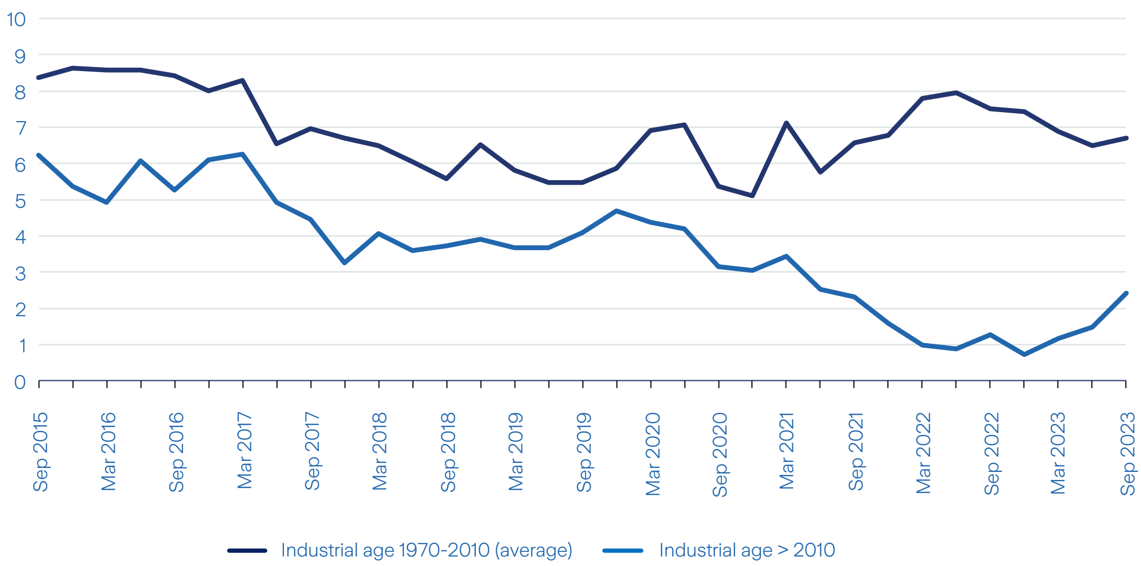
Over the last decade, the logistics sector greatly benefited from a pronounced shift in consumer behaviour. This took on an entirely new dimension during pandemic-induced lockdown measures and pursuant supply chain disruptions. As tenants sought to right size their space requirements in real time in an effort to efficiently serve end users, rental growth revved-up.

> While supply chain disruptions have eased materially, supply chain reconfiguration is a more endearing phenomenon.

Catalysed by rising geopolitical tensions, an increasingly powerful development has been the rise of re-, near-and friend-shoring. These related trade buzzwords speak to shifting manufacturing and commercial patterns, which ultimately have a real estate component. Countries with a lower cost of production, and amicable trade relations with key consumer markets are beneficiaries. Central and Eastern European and certain Southeast Asian and Latin American countries are seeing the greatest interest. In a recent **thought piece**, Zurich Insurance's MSME team chronicle's Mexico's favourable trade relationship with the US, its low labour costs and abundant skilled workforce, as an attractive nearshoring destination. It's no wonder why logistics operators and investors are looking to places like Monterey and Guadalajara.

Despite softening demand dynamics in recent quarters, logistics re-leasing rates are exceeding inflation in many global markets. This supports NOI and contributes to our still-favourable view of the sector. While recessionary risks in key countries pose a headwind for the sector in 2024, structural growth components compensate. As tenants balance the need for operational and cost efficiencies, modern facilities proximate to employment centres look resilient to well-documented challenges. Taking the UK as an example, while vacancy rates for newer assets have risen, they remain historically low and contrast notably to older properties (Figure 9).

Figure 9: UK industrial vacancy rate by vintage, %

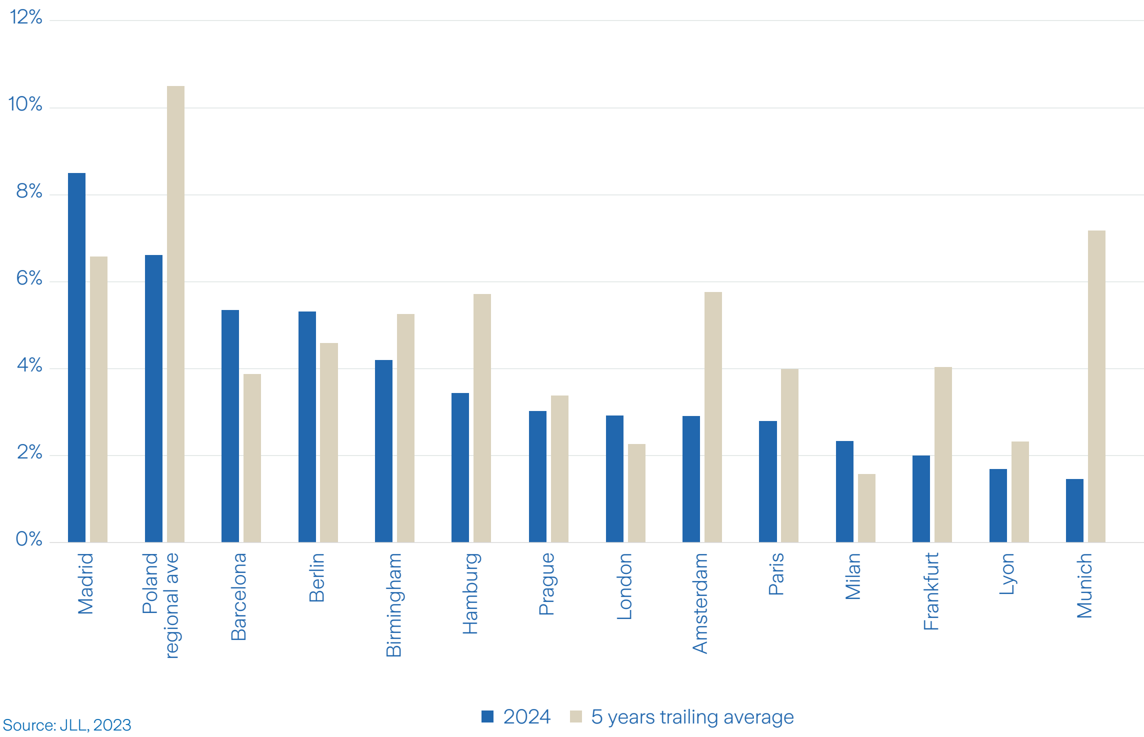


Source: MSCI, Q3 2023

This makes sense, not only in the UK but beyond, as robotics and advanced technologies are increasingly integrated into logistics facilities and this tends to be best deployed into newer buildings. It's also a reason why provision to ample affordable power is becoming an important space determinant. A knock on effect is a push to retrofit warehouse rooftops with photovoltaic panels to generate additional on-site energy. Such an approach can not only be monetised but also contributes to improving sustainability criteria.

The abrupt change in capital markets has tempered developer sentiment. And even though construction cost inflation has subsided from heady highs, fewer speculative projects are coming out of the ground compared with recent years. Figures 10 illustrates the change in development dynamics in Europe. Current pipelines as a share of total stock have subsided in key markets, with the recalibration in the Polish regions, Munich and Amsterdam particularly pronounced. A reduction in deliveries implies less available modern space over the medium term to cater to the occupational trends we've addressed here. This should ultimately help keep pricing power in the hands of landlords, making the sector a top performer.

Figure 10: Stock under construction as % of total stock



Source: JLL, 2023

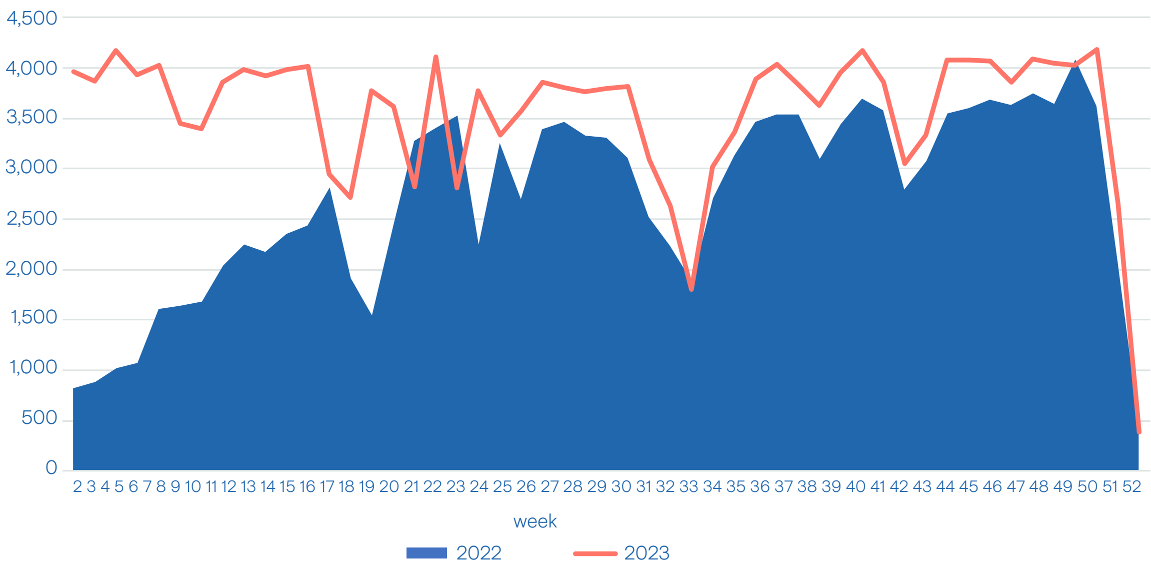
4. The future of office, continued

In our **2023 mid-year outlook** we argued that the demise of the office as a result of remote working has been grossly overstated. As we move further away from the mobility-restricted pandemic experience, we have further evidence to support the assertion.

> Office life is adjusting to past norms: routine work is now routinely being done in the office, teams are choosing to connect in-person and meetings with external guests have picked up.

Admittedly return to office (RTO) rates still vary around the globe, but space utilisation is the best it's been in four years. We have evidence from our Corporate Center in Zurich to back this up (Figure 11).

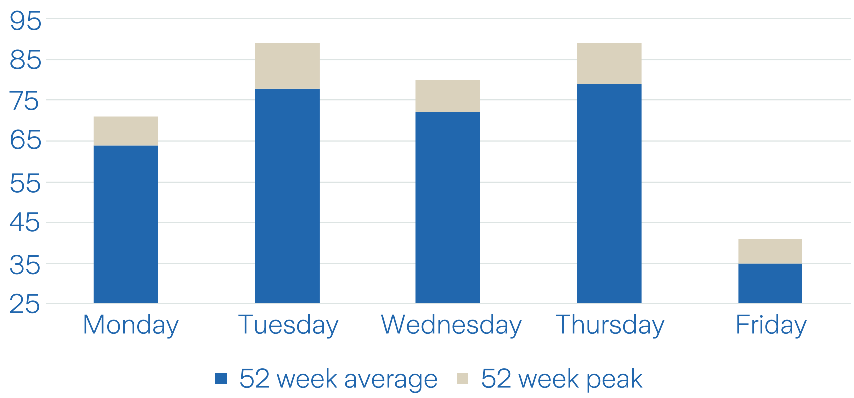
Figure 11: Employee visits at our Corporate Headquarters in Zurich in 2023, number of people per week



Source: Zurich Insurance Group

Also, the number of external meetings is up 40% year-on-year and afterwork social events are back to pre-pandemic levels. Mondays are surprisingly busy. On Tuesdays and Thursdays the building can reach near full capacity, and Fridays, well that's a great day for quiet, focused office work (Figure 12).

Figure 12: Average usage of our corporate headquarters in Zurich by day of the week in 2023, % occupuied



Source: Zurich Insurance Group

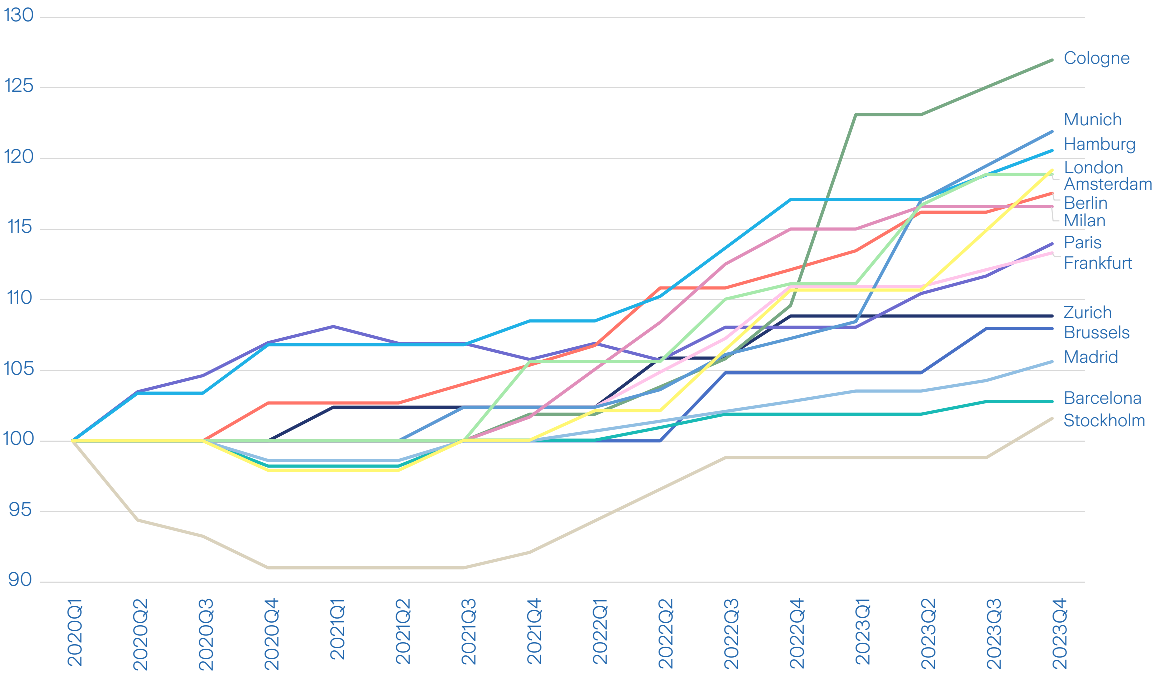
Looking forward, we see RTO trends continuing to evolve positively. This is because the incentives and constraints faced by employers and employees are unlikely to be the same as those of the past four years. Indeed, more employers are taking an interventionist approach, either explicitly insisting on a greater in-office presence from their workforce or by rewarding those that do come in. Changes in the macroeconomic environment in 2024 will also lead to a shift in the dynamics of the job market, acting as a further catalyst for office presenteeism. Furthermore, greater competition for jobs among employees and prospective employers implies that fewer remote working days will need to be offered to recruit and retain talent.

We continue to see physical office space as critical for companies' needs. Owing to this, the sector will play an integral role within diversified real estate portfolios. However, the definition of the prime office has narrowed. A "best versus the rest" trend is increasingly evident. In Europe where overall demand has softened in many markets, prime rents have held up well. In fact in certain smaller markets where there has been a persistent lack of grade A space, rental growth has been supercharged in recent quarters. (Figures 13 and 14).

Figure 13: Long run office take-up (2013-2023) vs. past four quarters, %

Source: JLL

Figure 14: Prime office rent index, Q1 2020 = 100



Source: JLL

Zurich Insurance's approach to investing in the office sector continues to be refined. The number of cities where we will consider deploying strategies is smaller than just a few years ago, and we are doubling down on submarkets where we've historically generated favourable outcomes. We prefer flexible floor plates, ideally in the range of 500-2,000 square meters and seek to meet evolving tenant expectations by providing healthy and productive space. We'll achieve this by acquiring and transforming well-located buildings with leading environmental and wellness credentials. Success in delivering such outcomes requires proactive tenant engagement, diligent cap-ex accounting and improved operational efficiencies.

5. Climate 2024: emergency, urgency and resiliency

The **World Economic Forum's Global Risks Perception Survey 2023-2024**, which was produced in strategic partnership with Zurich Insurance Group, makes for a sobering read. Respondents anticipate environmental risks intensifying in their severity to dominate the longer-term global risks landscape (Table 1).

Table 1: Global risks ranked by severity over the short and long term (10 years)

10 years	
1st	Extreme weather events
2nd	Critical change to Earth systems
3rd	Biodiversity loss and ecosystem collapse
4th	Natural resource shortages
5th	Misinformation and disinformation
6th	Adverse outcomes of AI technologies
7th	Involuntary migration
8th	Cyber insecurity
9th	Societal polarization
10th	Pollution

Risk categories

Environmental   Societal   Technological

World Economic Forum Global Risks, Perception Survey 2023-2024

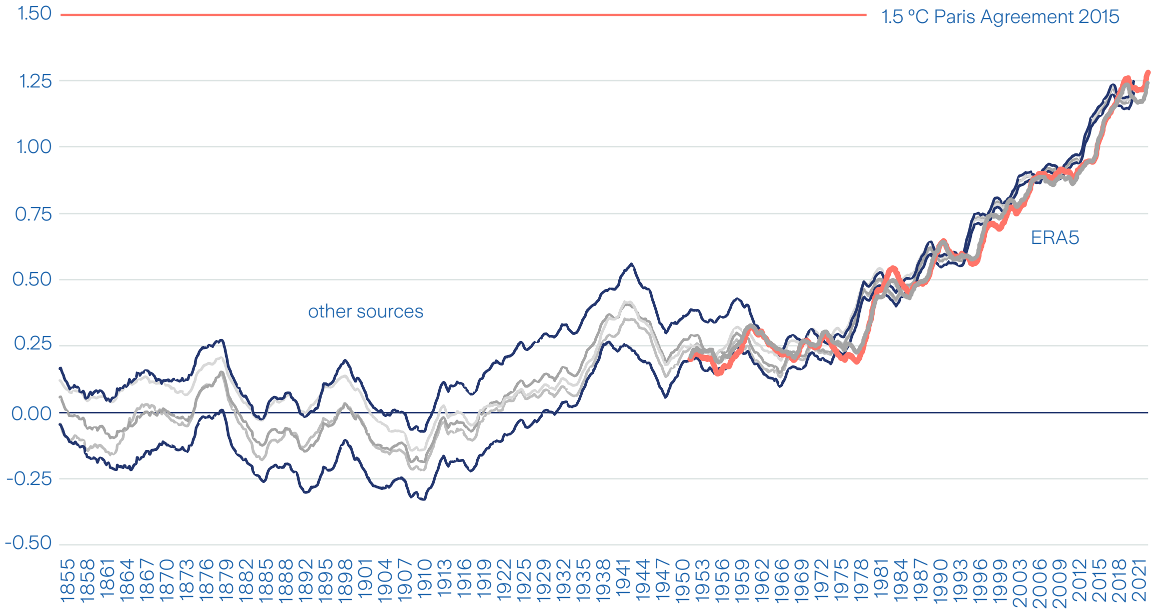
Thresholds for large-scale changes to the natural environment are likely to be exceeded within the next decade. Worryingly, the pace and scale of climate change adaptation efforts is falling short. Yet the acknowledgement of these stark risks comes at a time when addressing the climate crisis has become more complex. In some places, anti-ESG rhetoric is influencing political discourse with governments watering down climate commitments.

> For real estate, higher interest rates threaten to distract investors from staying on the path to net zero.

The challenges are no less complex for those real estate investors that grasp the urgency of the climate crisis and are committed to decarbonising their portfolios. The clock is ticking closer to self-imposed dates when progress on ESG pledges need to be demonstrated. Reputational damages for not meeting these are real. At the same time, new regulations are coming into force. Companies operating in the European Union will have to comply with the Corporate Sustainability Reporting Directive (CSRD) effective January 2024. In the U.S., the Securities and Exchange Commission is expected to announce rules on climate change disclosure later in the year. This will include attestation of scope 1 and 2 greenhouse gas emissions for larger companies as well as disclosures for scope 3 emissions.

Real estate investors making strides on their path to net zero will likely be disheartened by the fact that 2023 was the warmest calendar year in global temperature data records going back to 1850 (Figure 15).

Figure 15: Global surface temperature: increase above pre-industrial level (1950-1900)
Five year average temperature change in °C



Source: Copernicus Climate Change Service (C3S), 2023

A warmer world coupled with the increased frequency and severity of extreme weather events is beginning to force investors to think differently about climate-related physical risk.

> Asset adaptation and resiliency are taking on new dimensions.

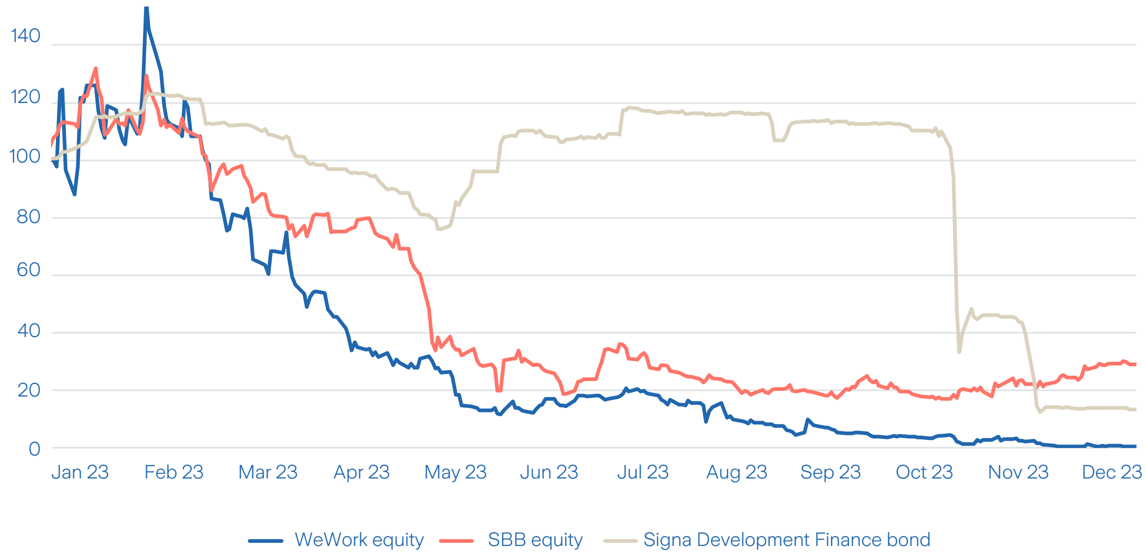
The use of hyper-local data, possibly aided by AI, can help identify asset specific hazards. These learnings can be applied to selecting appropriate materials and designs for construction and retrofitting. Resiliency planning should also consider operational continuity. Buildings that are up and running immediately after a severe weather event should command a higher value.

In 2024, the task list for real estate investors and operators is formidable. In addition to making demonstrable progress on decarbonisation promises and addressing transitional climate risk at asset level, they will have to navigate new multi-jurisdictional regulations. Tenants and lenders are asking more sophisticated questions; asset managers must adapt new policies. Sustainability data needs to be translated into insights and action. Stranded asset risks loom larger while planning for operational resilience takes on greater urgency. And all of this is set against a backdrop of structural disruption, challenging capital markets and softening economic conditions.

6. Lessons learnt from the struggles of WeWork, Signa and SBB

Last year saw the unravelling of once protagonist property companies WeWork, Signa Group and SBB (Figure 16). While the three firms have fundamentally different business models as well as sector and geographic orientations there are important lessons to be learnt from their collective falls from grace.

Figure 16: Equity and bond performance during 2023 index, 100 = Jan 1, 2023



Source: LSEG Workspace

The story of WeWork's rise and subsequent fall is well chronicled. Its founder sought to "elevate the world's consciousness" by revolutionising the office sector. That revolution was predicated on arbitraging long office leases with expensive flexible shorter leases. Money flowed in and hope valuations reached astronomical levels. However, the company's supercharged expansion ran up against increased competition from operators who easily replicated the flexible working model, often at a lower price point. The combined forces of the pandemic and weak occupancy rates as hybrid working took hold proved too much. In late 2023, the company filed for bankruptcy protection and sought to restructure its more than $13bn in lease obligations with landlords.

Austrian domiciled, Signa Holding, is a majority owner of some of Europe's most iconic department stores, a skyscraper developer and collector of trophy assets from Vienna to New York. Having received backing from well-capitalised investors and lenders, the company's GAV grew rapidly. However, it also has a complex ownership structure of hundreds of corporate entities and offshore trusts. And it is overleveraged. Given its opaque structure, total debts owed by the network of companies are unknown but estimated to be in excess of €15bn. Despite owning super prime assets in economically vibrant cities, Signa's debt-fuelled business model has been hit by rising interest rates. And it too filed for insolvency in 2023. In the absence of being recapitalised by existing investors, a fire sale of assets looks inevitable, which could wipe out the positions of lenders, JV partners and minority shareholders.

Swedish listed SBB was founded with the objective of institutionalising social infrastructure real estate in the Nordics. The company targeted assets backed by quasi-governmental bodies on triple net leases and saw its portfolio expand rapidly through a debt-fuelled external growth strategy. But by mid-2022, the company's overall leverage reached c. 70%, making it the most indebted major listed real estate company in Europe. SBB's capital structure is uniquely complex with layers of debt and quasi-equity instruments. Not only that but, the firm's corporate governance is impaired. Its founder and former CEO has more than 30% voting power. As financing conditions deteriorated over the past 18 months and the market saw rising cap rates, the share price came under significant pressure, raising existential fears. SBB needs to refinance the equivalent of c. 50% of its property portfolio value over the coming two years and is reliant on banks willing to roll over most of its secured debt.

So what are some of the lessons learnt from these company struggles?

First off, **capital structures matter**. These three companies were either overly reliant on cheap money to fuel growth and justify valuations or had debt maturity profiles which ultimately worked against them. Just a few years ago, it was easy to extrapolate lower interest rates forever, favouring supercharged growth with short dated debt. The past year has taught us that lower forever is no longer.

Secondly, **governance matters**. Investors should be warry of smooth talking, flamboyant founders who hold outsized influence within companies. Their interests may not be aligned with JV partners and shareholders. It's a red flag when executive optimism borders on hubris. Investors should also be sceptical of convoluted corporate organisational charts and non-conventional debt and equity structures. If either are too difficult to understand, it may be too difficult getting your money back.

Thirdly, **diversification matters**. Exposure to these companies would have weighed on performance over the past couple years. But a diversified portfolio would have helped offset specific risk. Diversification transcends property sectors and geographies and should consider debt maturity profiles, business sector exposure as well as manager expertise.

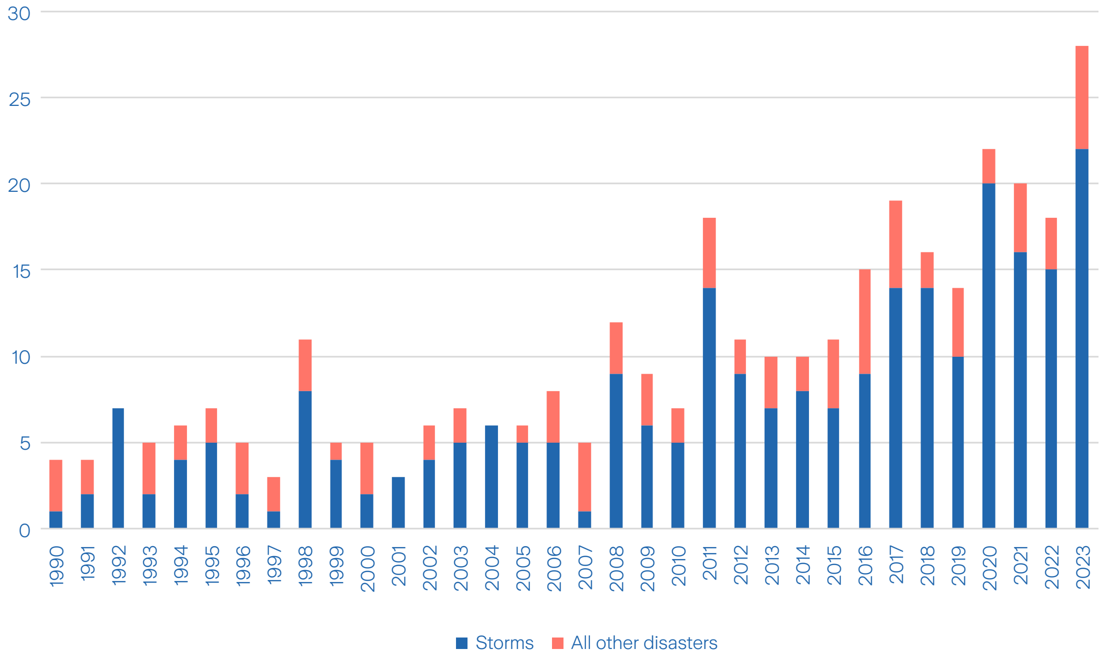
All three companies leave lasting legacies. Their assets will of course survive, but likely in different structures and at much lower valuations, having cost investors dearly.

7. Rising insurance premiums will shape investor attitudes

As mentioned earlier in our Outlook, the spectre of climate change looms large over the real estate sector. For asset owners, changing weather patterns have a greater potential to impact portfolio performance in several ways, including physical damage and transition costs. As a consequence, decarbonization, energy efficiency, climate resilience, and access to resources like power and water have all taken on a greater importance for investment decision making. But the trend we see taking on added influence is increasing insurance costs and declining insurance availability.

In the United States, there were 28 separate billion-dollar weather and climate disaster events in 2023 (Figure 17).

Figure 17: Number of billion-dollar natural disasters



Source: National Centers for Environmental Information

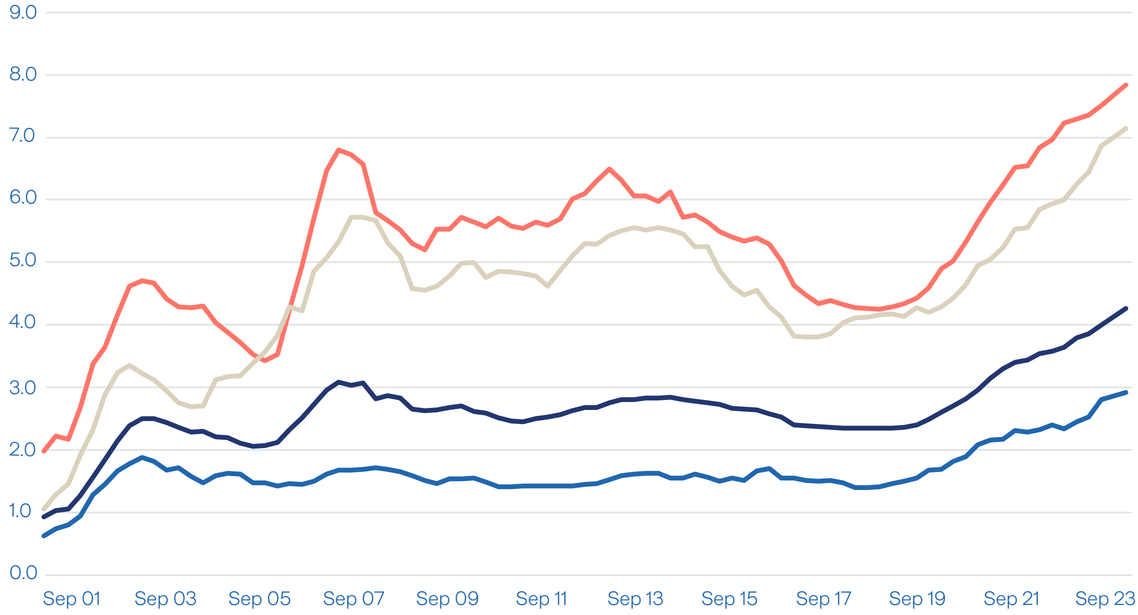
From tornadoes and floods to wild fires and heat waves, the historic number of events exceeded the annual cost of previous disaster events on an inflation-adjusted basis. A logical consequence of this trend is that

> insurance premia will have to increase, posing additional cost burdens and operational challenges for asset owners and occupiers.

Historically, insurance has been only a minor concern for commercial property owners, accounting for a low single digit percentage of NOI. And even then it was routinely paid or reimbursed by tenants. But the recent spike in costs is forcing investors to take note. Asset owners who would normally pass insurance costs onto tenants are right to worry that they will resist or that higher premia might limit future rent increases. If the owner pays, that erodes returns. Of course this assumes that insurance is available, which is no longer a given.

According to the National Council of Real Estate Investment Fiduciaries (NCREIF), insurance costs in the U.S. as a share of operating expenses nearly doubled over the past five years (Figure 18).

Figure 18: NCREIF Property Index insurance costs as a share of operating expenses, %.



Source: NCREIF, latest = Q3 2023

Los Angeles and Miami registered the highest insurance costs at 7.8% and 7.1%, respectively. This will probably not come as a surprise, given the prominent risks faced by properties in these locations. In California, these include wildfires and earthquakes, while for Florida hurricanes, floods, and sinkholes are high-profile risks. But even Minneapolis, a city whose exposure to such risks is decidedly lower, saw insurance premia as a share of operating expenses rise. While the impact of higher insurance costs may not have been as pronounced as tighter monetary policy has been on real estate performance, they are sure to play a greater role in shaping investor attitudes going forward.

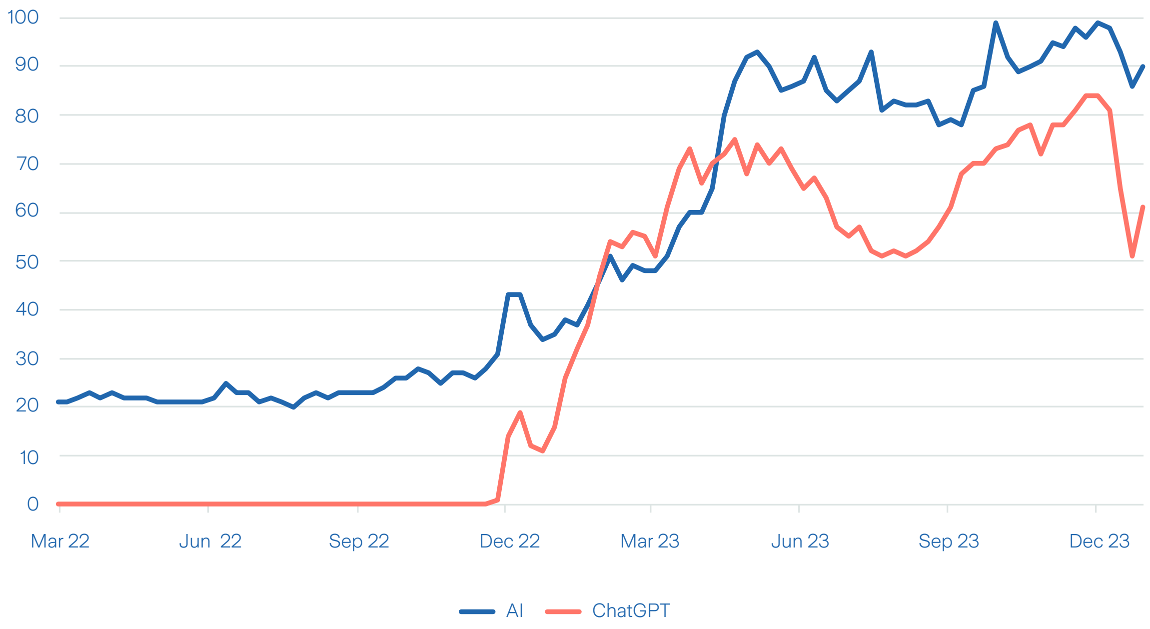
> As an insurance company, we feel that we have a unique perspective of the challenges associated with climate related physical risk.

8. The net impact of AI for real estate is not clear cut

Artificial intelligence has captivated mainstream attention (Figure 19). ChatGPT has become a household name (Figure 20) and companies with an AI orientation have seen supercharged valuations. The incredible technology is moving exceptionally fast and has very smart people and a lot of money behind it. There is tremendous upside potential. The professional services industry is increasingly adopting the emergent technology. Zurich Insurance recently rolled out its own privately hosted generative AI chatbot in an effort to boost productivity but also protect proprietary information. In fact,

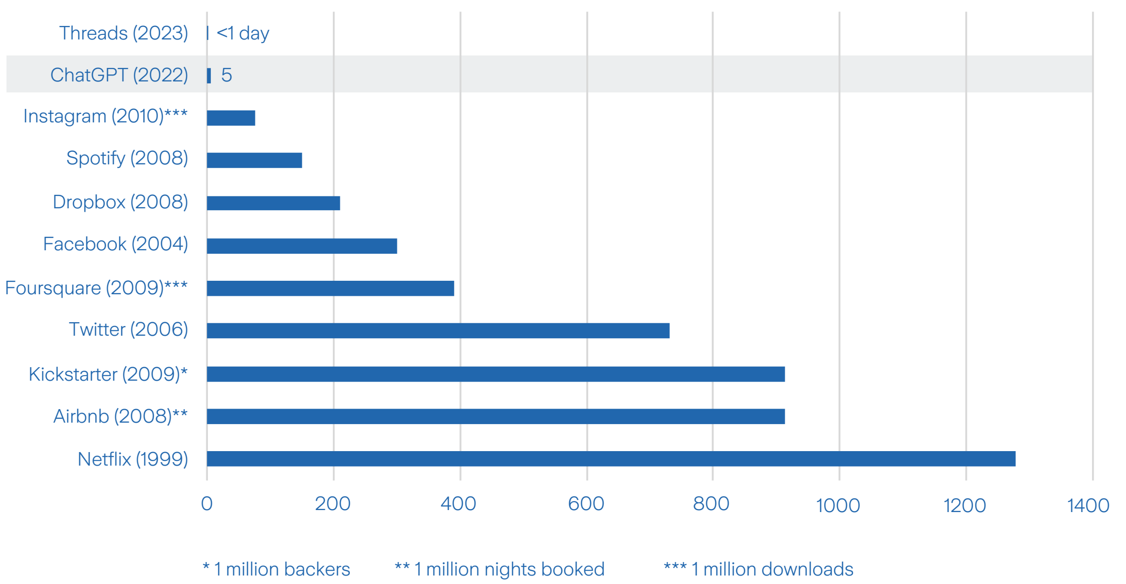
> ZuriChat deserves credit for contributing to this Outlook. It suggests that the net impact of AI for real estate is not clear cut.

Figure 19: Worldwide Google search terms



Source: Google

Figure 20: Time taken (days) to reach one million users



Source: Simialrweb, January 2024

AI will become a powerful tool to help analyse property markets, enabling quicker and more informed investment decision making. It can foster efficiencies in the construction sector as well as enable predictive building maintenance. It will accelerate mundane property management processes, including ESG reporting and monitoring. AI has the potential to aid asset valuations, inform insurance underwriting as well as simplify portfolio modelling. The applications are myriad and mind-boggling.

But proprietary content creators are clearly nervous. We recently signed a contract with an established real estate insights provider that included an AI clause. We are obliged not to integrate their intellectual property into deep learning tools. Similarly we are aware of architects reluctant to use the technology for fear of breaching client confidentiality or losing control of their creations. These logical reactions by a unique content providers are small examples of the fits and starts this fledgling technology faces in its adaption to the wider property industry.

Given the efficiencies that AI can deliver, it begs the question whether the technology will be a job creator or destructor.

> Our near term concern isn't a mass shedding of white collar jobs and workforce upheaval – commonly voiced fears.

On the contrary, we see AI stimulating business investment and catalysing innovation. Furthermore, we see AI boosting productivity gains, with those enterprises embracing the technology positioned for growth, especially as financing conditions ease. This should begin to alleviate some of the softness in tech-oriented office demand that we saw in recent quarters. Nodes of AI excellence like the San Francisco Bay Area, Boston, Toronto, Berlin, London and Beijing are well positioned to benefit. But given the uncertainty around AI's lasting impact, commercial real estate occupiers are likely to demand greater flexibility with their space obligations.

For offices this means shorter leases with scope to expand and contract. For logistics assets, it implies greater onsite power requirements and proximity to critical digital infrastructure. Data centres are an obvious winner.

Rather the bigger concern we see with AI resides outside of the real estate universe. The technology is moving faster than the governance to control it. Its inevitable use to influence public opinion by dangerous actors has the potential to polarize society and impact the many elections that are occurring this year. In fact "misinformation and disinformation" is cited as the number one risk in the World Economic Forum's Global Risks Perception Survey 2023-2024. The potential negative consequences for international relations and market dynamics should not be underestimated. The risks posed by AI are similarly myriad and mind-boggling!

> Given the uncertainty around AI's lasting impact, commercial real estate occupiers are likely to demand greater flexibility with their space obligations.

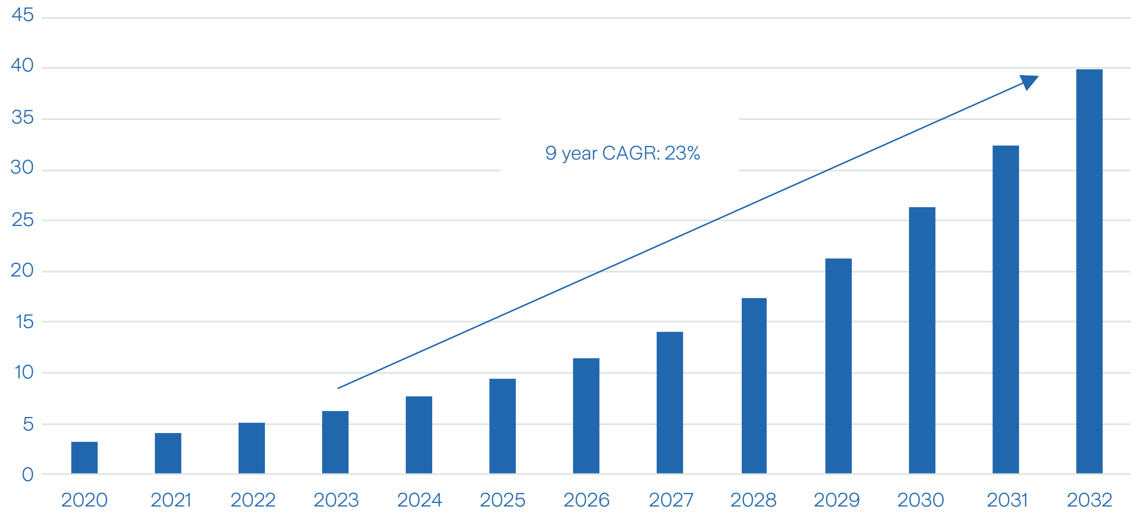
9. Unearthing Vertical Farming

In our 2024 investment recommendations, we identified a preference towards new economy versus the old. Vertical farming, along with other food-oriented real estate, is one such route. As with other megatrends, the Covid pandemic put a spotlight on the challenges facing agricultural systems, as supply chain disruptions and labour shortages complicated access to healthy food. This was exacerbated by the war in Ukraine, which lead to a sharp rise in global food prices.

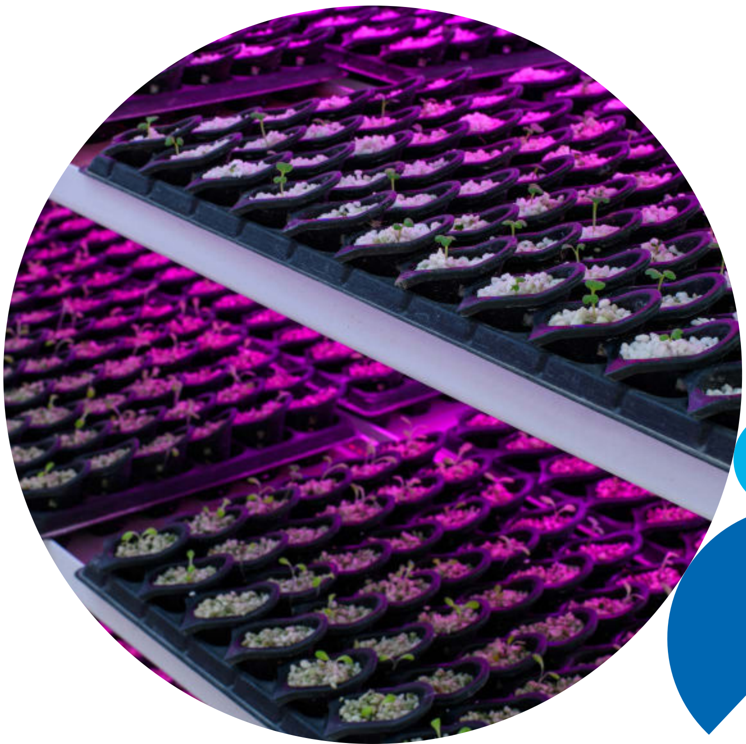
Feeding a growing global population is a monumental challenge. This comes as more people are facing food insecurity because of the effects of climate change, geopolitical conflict and diminishing arable land. Lower income countries find themselves in an especially precarious position. But communities in higher-income countries also face challenges in terms of reliable access to healthy and affordable food.

Addressing these challenges will require a combination of higher crop yields, dietary changes, and an expansion of areas under cultivation—all of which are difficult for real estate investors to influence in a meaningful way. It will also require innovation in food and agricultural technologies. And this is where they can lean in. As evidenced by venture capital and private equity fundings from diverse high-profile investors, vertical farming is primed for growth (Figure 21). And real estate investors and operators have a critical role to play, because ultimately, they will provide the spaces to grow tomorrow's crops.

Figure 21: Forecasted growth of the global vertical farming market size, USBbn



Source: Precedence Research, 2024



In many instances, large-scale vertical farms are housed in modern warehouse facilities. The physical attributes, proximity to existing distribution networks and lease structures are comparable to those for industrial and logistics tenants. Vertical farming facilities also can resemble data centres, in terms of power requirements and capital-intensive fitouts. There are similarities to life sciences due to the activities undertaken within the buildings as well as their operationally intensive nature. Also, owing to the embryonic stage of large-scale vertical farming, operators may face startup challenges.

From an investment perspective, one of the best ways of accessing the segment quickly might be to look at an existing logistics portfolio to see whether there is a sufficiently powered building that could accommodate a vertical farming operation. For new, larger scale, direct investments, densely populated affluent cities that import a significant proportion of food should be a principal focus. It could also include locations previously not considered for investment, such as the Middle East or Africa, where solar energy could economically power facilities and help eliminate the reliance on food imports and volatile commodity markets. It is equally important to acknowledge that interesting smaller scale opportunities may exist elsewhere, including as parts of mixed-use projects or integrated into existing buildings.

We recommend considering a full suite of real asset strategies (direct/indirect, listed/unlisted; credit/equity; infrastructure/real estate) to execute a vertical farming strategy in markets and with operators where the opportunity set presents attractive fundamentals. Similarly, there may be compelling ways of accessing the segment via private equity or ag-tech investments.

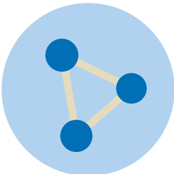
10. Preferred investment strategies – a 2024 tilt

In our 2023 mid-year outlook our preferred global investment strategies were organised by sector. We emphasised an overweight call to modern logistics facilities with leading sustainability credentials in in-fill locations where values are underpinned by alternative uses. We expressed conviction in the affordable for-rent residential segment though acknowledged how increased governmental intervention could impact performance. We cited alternative residential tenures such as student housing or micro living as ways to circumvent this challenge. We argued that the death of the office was grossly overstated but empathised with a cautious stance as the sector finds occupational equilibrium. And we advocated taking a more constructive approach toward retail due to resilient post-pandemic footfall, redundant space having been repurposed to other uses as well as an attractive running yield. Frankly, these sector calls still resonate.

The nuance in 2024 is how these conviction calls will be accessed. Succinctly stated,

> we see investors requiring enhanced returns for core strategies and preferring credit over equity, fund secondary trades over primary subscriptions, and the new economy over the old.

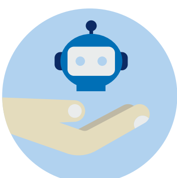
Here is what we mean:



Enhanced returns for core strategies
Given higher financing costs, reduced liquidity and a softening economic backdrop, investors are right to require higher returns from real estate. However this needn't come with additional risk. By providing creative capital solutions, assets with core risk profiles can be accessed at compelling pricing versus a couple of years ago, thus helping generate a more attractive go forward return profile. Rescue capital, structured deals and vendor financing should be in scope. Furthermore, given risk aversion, new development for many property segments has slowed materially. For structurally supported property segments, this presents an attractive entry point to commit to a forward purchase in anticipation of favourably evolving supply/demand dynamics.

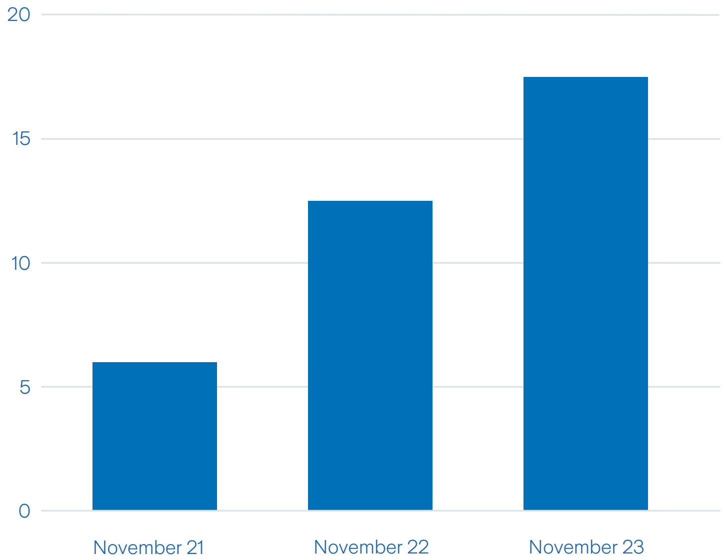
Credit over equity
In an environment where capital values continue to face downward pressure, real estate credit offers a more secure position in the capital stack. As loans secured by repriced real estate come due, providing replacement finance can deliver equity-like returns for taking credit risk. This is helped by the fact that commercial real estate loans tend to have lender-friendly terms and documentation. Also interest rate coverage ratios are better than they were going into past corrections. The opportunity is stepping in where banks are stepping back. But as conviction calls become crowded, the challenge may be deal flow. Not all assets that require refinancing are aligned with our preferred investment strategies. Furthermore, real estate credit investments, by definition, forego upside potential. Those equity investors with no or low gearing today, but able to access credit once accretive to returns, are well placed.

Fund secondary trades over primary subscriptions
While real estate fund secondaries are not heavily traded and real time pricing may at times be opaque, the current sales interest reported by market makers suggests there is value to be had in well performing funds around the globe. Buying a discounted fund share circumvents any capital queue, providing immediate access to returns at a favourable basis. The rational for sale shouldn't necessarily be read as a commentary on fund performance prospects. Motivated sellers may prioritise immediate liquidity versus waiting in redemption queues. And intention surveys suggest investors are increasingly motivated by the opportunity (Figure 22). Of the highlighted 2024 investment themes, the window on this opportunity is likely to close first as valuation uncertainty recedes.



The new economy over the old
Over the past few years, investors have consistently highlighted an intention to pivot to property sectors that were once considered niche but are now in the path of structural growth (Table 2). While the preference hierarchy has shifted over time, such property types might include data centres, life sciences, medical offices or student accommodation. There also is a blurring of the lines for infrastructure-like real estate. In our 2023 mid-year outlook we asserted that these property types will go on to make up a greater share of balanced real estate portfolios. The challenge is how best to access them at scale as sector expertise can be a limiting factor. In addition to traditional equity ownership, listed real estate companies, fund vehicles or even credit should be considered.

Figure 22: Preqin investor survey: real estate secondaries presenting attractive opportunities in the next 12 months
% of survey respondents



Source: Preqin

Table 2: European real estate sector prospects in 2024

	Rank	Sector	Overall investment prospects
"new economy"	1	New energy infrastructure	4.50
"new economy"	2	Data centres	4.36
"new economy"	3	Healthcare	4.11
"new economy"	4	Student housing	4.08
"new economy"	5	Retirement/assisted living	4.07
"new economy"	6	Self-storage facilities	4.06
	7	Logistics facilities	4.01
	8	Co-living	3.98
	9	Serviced apartments	3.97
	10	Private rented residential	3.94
	11	Life sciences	3.93
	12	Industrial/warehouse	3.93
	13	Affordable housing	3.91
	14	Hotels	3.80
	15	Social housing	3.75
	16	Leisure	3.55
	17	Housebuilding for sale	3.47
	18	Flexible /serviced offices	3.33
"old economy"	19	Parking	3.20
"old economy"	20	Retail parks	3.19
"old economy"	21	Central city offices	3.06
"old economy"	22	High street shops	2.92
"old economy"	23	Business parks	2.71
"old economy"	24	City centre shopping centres	2.58
"old economy"	25	Out-of-town shopping centres	2.53
"old economy"	26	Suburban offices	2.10

Source: PwC/ULU Emerging Trends in Real Estate, 2024.

Note: respondents scored sector prospects on a scale of 1=very poor to 5=excellent, and the scores or each sector are averages

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