The 2022 Real Estate Roundtable

The Case For Real Estate Today

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In this period of heightened economic risk, it is important to recognize that real estate investments have always offered very strong diversification benefits versus other asset classes, says Mike Bessell, Managing Director European Investment Strategist – Real Estate, at Invesco Real Estate. In the *Benefits and Pensions Monitor* Roundtable 'The Case For Real Estate Today' with Christina Iacoucci, Canadian Chief Investment Officer and Head of Investment Management Canada at BentallGreenOak, and Kim Politzer, Director of Research, European Real Estate, at Fidelity International, Bessell said asset allocators in any economic circumstance should be looking at it particularly when concerned around economic growth, market volatility, and inflation pressures.

Another aspect of real estate is the occupiers who add extra diversification, said Politzer. Since 60 per cent of tenants in real estate are unlisted, the asset provides a very different income stream from that.

Within commercial real estate, Iacoucci noted there are also stable cash flows with the opportunity for capital appreciation. "Quite frankly, given where interest rates are going, it's a pretty good hedge against inflation," she said.

What economic and demographic trends are you paying attention to as you evaluate opportunities for future investment activity?

Iacoucci: I'm keeping a close eye on immigration which is fueling Canada's population growth at two times the rate of any other G7 country. We're expected to welcome more than 1.3 million people in the country over the next three years or so and that doesn't include the non-permanent residents – foreign students or foreign temporary workers.

These new Canadians need apartments to live in and grocery stores to shop in. They need office buildings to work in and warehouses to fulfill their online orders.

Right now, we're favouring purpose built rental apartments, logistics, and needs-based retail over challenged sectors like commodity office or discretionary retail. And we're focusing on sectors that are the underpinning for economic, demographic, and technological shifts. Tech disruption and innovation have greatly influenced how we now live, work, and play, with significant implications to traditional real estate sectors and some new ones, such as life sciences and data centres. Data has become an essential service just like power, food, and water. This secular demand story is at various stages of maturity across global markets, but it is still in its infancy in Canada, where there is plenty of room for growth.

The evolution of the supply chain is also driving strong investor returns in the logistics sector. The pandemic exposed vulnerabilities in the very complex global supply chain. As a result, firms are now increasing their geographic diversification including onshoring and near-shoring and carrying higher inventory levels to reduce those risks. We're seeing this as an attractive opportunity. We also see attractive opportunities in cold storage where consumers' preferences are

shifting towards more fresh foods and multimodal ordering and delivery.

Finally, housing supply and affordability remain a challenge. Professionally-managed, purpose-built rental apartments are a defensive investment opportunity and a part of the solution that should not be overlooked.

Multifamily offers real estate portfolios diversification of cash flow through the business cycles and the short-term duration of those leases offers inflation protection.

Bessell: Almost any changing pattern you can see in human life and human behaviour is something that needs to be accommodated in real estate somehow. Therefore, our opportunities at the moment are where those trends come from.

The immigration story for Canada is very strong growth, but across the developed world, we're seeing strong urbanization trends that need to be supported in terms of where people live, work, and play. This is driving a shift in how we think about things. The classic thought of a U.S. city where you have a residential suburb, a collection of office towers, and a shopping district is not the case in cities like Paris where they are talking about a much more integrated model.

Everywhere in the world our lives need to be kept under a roof one way or another and that's the real estate opportunity. So it's just looking at those changes as they come through and looking at which have an economic value which can monetized.

What are the key drivers of ESG (environmental, social, and governance) in real estate investing?

Politzer: There are two big push factors.

First is the regulatory environment. With all the various governments trying to hit net zero by 2050, we're starting to see more regulation on how the real estate market is going to hit that. In Europe, we're starting to see a ramping up of minimum energy efficiency standard regulations.

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But there's also the push factor from investors themselves. We know that the millennial generation is very interested in environmental issues and are looking for pension plans and investment opportunities that are aligned with their own values.

Increasingly, we are seeing the institutional investor base looking at ESG credentials of funds in terms of their ambitions to hit net-zero carbon targets and their social impact because real estate has a huge impact on the communities around it.

Governance is also incredibly important. We've seen a number of issues around greenwashing and the challenges that it brings. We have institutions that are trying to improve that governance from a real estate perspective to deliver a lot more clarity on how well the industry is progressing towards delivering much greener real estate and helping hit some of those ambitious targets to decarbonize the environment.

How far ahead is Europe in terms of incorporating ESG into real estate portfolios?

Bessell: In my experience, we're seeing Europe pushing hard on a broad range of ESG considerations. However, we must remember ESG in real estate is two things – the overall construction process and the in-use sustainability. Real estate managers and corporate tenants are being asked to explain what they're doing, how sustainable their practices are, and how they are minimizing their emissions in the way they use those buildings. We've seen this in Europe and it is starting to spread elsewhere.

Iacoucci: One of the most important things to keep in mind is there is a cost to not moving on ESG. Real estate has two main value components – annual cash flow and exit value. As the industry moves towards net-zero, the users and investors of real estate in North America and Europe will expect and eventually demand assets that have the ability to hit net-zero targets. This will directly impact the leasability and liquidity of assets. If an asset is not moving towards net-zero, will tenants want to lease there? Will investors want to buy those assets? There is definitely a cost to implementing ESG strategies, but I believe the cost of not having these strategies is much higher.

Is there evidence of a green premium?

Iacoucci: The market is moving towards green building best practices now more than ever and ESG-committed assets are what investors are looking for in their portfolios. Green is especially good for office building owners. There is increasing evidence that LEED certified office buildings not only achieve higher rents and revenue than their counterparts, but can also outperform during recession and recovery periods – evidenced both post-global financial crisis and now post-pandemic.

Politzer: The green premium is probably more obvious in the discussions with occupiers rather than in discussions with investors. Investors have an expectation that we will be implementing policies that are consistent and expect to deliver a return that's responsible.

Our investors are definitely engaged on the subject, but they are not necessarily saying they are expecting an extra green premium to be delivered on core funds. They're just expecting the core fund to meet certain green standards.

The interesting bit is what the occupiers are looking for. At the moment, we're seeing a willingness to pay for better quality space, particularly for space that has high ESG credentials. Companies are finding that their employees are looking to see a strong ethical behaviour shown through the space being occupied. We're seeing much more focus on those factors when occupiers are looking at buildings.

Bessell: Increasingly in Europe, we're moving away from thinking about a premium value for green buildings. In terms of pricing, we're actually increasingly putting in a discount on those buildings that don't meet current standards.

In the U.S., that's further away, although there's clear evidence on leasing behaviour of a reasonable premium for the best LEED rated buildings there.

Is the current economic environment having any impact on ESG investing?

Iacoucci: I believe that sustainable investing will help reduce volatility in cash flows and asset pricing. Our approach is designed to match a range of client and investor risk and return expectations.

We go from property-level target setting to creating energy efficient improvements to reduce energy consumption and greenhouse gas (GHG) emissions. This gets to the heart of operating costs and being able to reduce those across all sectors within the real estate portfolios that we manage.

We created two proprietary programs at BentallGreenOak. One is related to climate adaptation planning, and this is all about climate risk and what does that really mean at the property level.

> TECH DISRUPTION AND INNOVATION HAVE GREATLY INFLUENCED HOW WE NOW LIVE, WORK, AND PLAY, WITH SIGNIFICANT IMPLICATIONS TO TRADITIONAL REAL ESTATE SECTORS AND SOME NEW ONES, SUCH AS LIFE SCIENCES AND DATA CENTRES
>
> - Iacoucci

We've also created a social impact tool that assesses the positive social impacts that real estate investments can have, tailored to each asset class.

Socioeconomic realities strengthen our conviction to continue this as a focus for our firm and for our clients and investors in all portfolios.

Bessell: ESG is now so embedded in the psyche that in most core markets, the most prime assets – high quality income streams and high quality assets in the best locations – have remained the most liquid. In the current uncertainty, those will be key to ensuring that investors who are active in the market at the moment maintain that interest.

Politzer: It's particularly important from a risk mitigation perspective. It's not a fad. It's not a nice to have. We do need to be taking all of this very seriously. Despite the economic conditions we're facing at the moment, the commitment to delivering buildings that are meeting high environmental standards, either through new construction or, probably more importantly, through refurbishments is critical. Obviously one of the biggest impacts we can have is not knocking down existing buildings, but refurbishing them to meet current standards otherwise we're creating more risk for portfolios and for investors. We can't limit our ESG focus simply because we're facing more challenging economic conditions.

What should real estate investors be thinking about beyond the near-term

Politzer: The danger always is that we get very sucked into the near-term risks. A lot of what I've been talking about to investors and internally has been around inflation and recession.

But real estate is a long-term investment, so it's really important that we think about making sure that our portfolios are positioned to take advantage of long-term structural themes and be prepared to buy in the next 12 months, rather than just thinking about the risks at the moment of acquiring. There are great opportunities out there – assets at attractive prices – which could allow the repositioning of portfolios to take advantage of some of those structural themes we're seeing.

The other thing we should be thinking about beyond the near-term is when do we want to put risk back on the table once we come out of this recession. That very much links back to ESG and refurbishment and to the opportunities to repurpose buildings in great locations and strong cities. The live, work, play environment is going to become more important as people think about how and where they want to live.

Bessell: Almost every facet of human life is housed in some shape or form by real estate and in key cities in developed parts of the world, land is not being newly created.

With the increasing focus on reducing carbon emissions, the value of the existing structures we have and the ability to rework is going to become even more of a focus.

In the medium term, we need to understand the inherent land value and the inherent frame of value of an existing structure and reimagining broader uses. If it's a location that isn't quite working, how can we be thinking differently about the strength of this location?

Over the next period, if we get a degree of market dislocation, the winners will be those who think more creatively about how to engage with the existing environment and to use it in a different way.

We need to get very much get out of this office logistics, residential retail blocks, siloed approach and be thinking much more flexibly.

Iacoucci: Investors need to be thinking about the resiliency of their assets from multiple lenses. Does it meet the tenants' needs? How does it fit into the neighbourhood? They need to assess what's changing around those assets and how real estate is going to continue to evolve. The lines are being blurred across property sectors and new alternative sectors are emerging which are expanding the opportunity set for institutional investors.

The pandemic turned things topsy turvy for real estate. How do you see this playing out over the next few years?

Iacoucci: There's a lot of different things at play. We're thinking about the future of office with remote work arrangements. This hybrid work environment is here to stay and the implications are far reaching beyond just office buildings. A reduction of office space impacts those buildings and the urban landscape – the bars, restaurants, small print shops, dry cleaners, and other retail service-oriented business that rely on the office work force.

The office is also becoming more of a community hub to foster culture and collaboration amongst employees, rather than a place just to do task-oriented work. What is that going to mean for the design of our office buildings?

Commodity type office is what will be hit hardest because people want to come to buildings where they can create these community hubs with buildings that are well located, newly constructed or renovated, and amenity-rich. I believe, more than ever, there's going to be a flight to quality, both from tenants and investors, and it's going to be something around placemaking.

Bessell: The one thing that we are incredibly focused on here is that it is going to be an incredibly local office trend, particularly around Toronto and other major urban centres where people have very long commutes, typically by car, but you also have large housing subdivisions. I can see why office stock is under considerable pressure. The idea of commuting to an office when you have a proper workstation at home is hugely unappealing.

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If you compare that, for example, to some Asian cities, there you have much smaller residential units and you often have multi-generation families within homes, you have a stronger culture of attending the office, and you have strong public transportation networks. Those are markets where we will see people returning to the office considerably more.

The relative winners and losers are going to be an absolutely critical point. We're seeing that in Europe. We came into the pandemic with far lower vacancy on average across European offices than we saw than in Asia/Pacific and in the U.S. Now, within bigger markets like London and Paris, we're seeing relative winners and losers. The best locations with high amenities around, those offices are seeing very, very strong tenant demand while other locations are losing out.

Iacoucci: Challenges in the retail sector have been evolving for years and the pandemic has certainly underscored many of the difficulties that we see today with growing online consumer consumption trends.

But it is important to note that not all retail is created equally and so a proper evaluation of this asset class requires an appreciation for context. The bifurcation between needs based/grocery store anchored centres versus enclosed malls or discretionary type retail has continued to escalate. The enclosed mall business is going through some tough evolutions to find their footing in a vastly different market for consumer goods. Whereas the needs based/grocery store anchored centres are growing in demand from both tenants and investors. For the more challenged assets, it's important to look beyond its current use. If you have a great site, what could the alternative uses be? What's the right mixed-use scenarios that can become mutually reinforcing? These are some of the questions that real estate fiduciaries are seized with finding answers to.

Politzer: Real estate is effectively a local business and to try and ascribe global trends to local real estate can be a risk. Certainly in Europe, we're seeing different takes on offices and different stories about retail. So it's making sure that you have that good local, on the ground knowledge of the local factors, be it what housing stock is looking like, what the commuting patterns are, and what the cultural appetite for going into physical shops is. Is it a social event or a simple transactional event?

All of these things affect the speed and the change that you see in those markets. ■

Source: Benefits and Pensions Monitor

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