Fidelity Compass

Impacting Investing with Direct Real Estate

Kim Politzer, Director of Research, European Real Estate

Bryan Borzykowski, Host

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Bryan Borzykowski: Hi and welcome to Fidelity Compass. I'm Bryan Borzykowski. Europe is in the midst of a unique climate goal related real estate phenomena. According to a report published by the European Commission earlier this year, EU buildings account for a third of energy related, direct and indirect emissions. As of today, over 80% of buildings in the EU do not meet 2050 net zero standards. As corporations look to improve their infrastructures' carbon footprint does a window of opportunity open up for investors? Joining me today to discuss the current commercial real estate landscape in Europe and where opportunities may lie ahead for investors is Fidelity European Real Estate Director of Research, Kim Politzer. Thanks for being here.

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Kim Politzer: Thank you.

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Bryan Borzykowski: Why don't we start off, give us a lay of the land. Interest rates are rising, that's obviously affecting real estate. What does kind of the global real estate market look like to you today?

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Kim Politzer: I think we're in a really interesting phase for global real estate. For the last ten years since the global financial crisis, really real estate investment has been driven by a steady shift inward of yields and that's been true across all regions globally. I think now, as we see quantitative tightening coming through, we're really going to start to see differences in regional responses. Part of that will be about regulation and legislation as you've said in your introduction. For Europe, it's very much going to be about decarbonization and sustainability of buildings. I think there are going to be other interesting divergences around demographic change, technological change and most importantly, supply and demand is really going to start being an important driver of outperformance again.

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Bryan Borzykowski: Specifically, more to Europe, what are you seeing there *[indecipherable]* same trends you're talking about in Europe. Where are some of the things you're looking at there?

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Kim Politzer: Clearly, the high inflation and the rapid change in the interest rate environment has really started to come through and impact the European real estate market. I think in some ways Europe has responded most rapidly to the changes in conditions partly because not only do we face the rising interest rates but we also have the war in Ukraine on our doorsteps so we've got the additional challenges of spiking energy prices, rising food prices, as well as the general move to this quantitative tightening that we're seeing across the world. That means we've seen real estate pricing react very quickly over the last two to three months. We've probably seen values in real estate fall by 5 to 10% since the middle of the year when values really peaked.

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We're really starting to see occupiers thinking very differently about what their peak requirements are of their space with energy efficiency really starting to climb up in their consciousness in terms of what they're looking for from their buildings. It's this combination of a rapidly adjusting pricing market but also some real changes in what occupiers want from their space that's making the market look really interesting at the moment.

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Bryan Borzykowski: I want to talk about how climate change impacts us but before we get into that, just in terms of prices falling, which you just mentioned, does that make buildings more attractive now that valuations are lower? How do you kind of look at that from the pricing from an attractiveness perspective?

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Kim Politzer: I think for investors that have capital I think Europe looks very attractive now. We think we'll probably see at least 100 basis points of that [indecipherable], that could equate to around about a 20 to 25% fall in values. This correction is happening very, very quickly. We think much of that correction will happen by the end of this year or by the latest the middle of next year. Suddenly there's a really interesting market to buy into so that means yields could have moved out from, probably around about the 3 to 4% mark for office and industrials to out to 4 1/2 to 5 1/2 or maybe even 6% in some markets. I think a lot of investors will find that quite attractive. Even more attractive is you then have a currency play on top of that. With a weak euro and a weak sterling against both the U.S. dollar and also for Canadians against the Canadian dollar, we think that a lot of investors will start to look at Europe very interestingly, not simply because we've seen a 20% fall in values but when you have the currency fall on top of that, real estate could look very, very cheap for overseas buyers.

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Bryan Borzykowski: On the climate change side, and I find this very interesting, I think a lot of broadly investors still think of real estate price, location, location, location but there is more to it than that going on here for opportunities. How is climate impacting the way people think about real estate?

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Kim Politzer: Pre-COVID, I would have said that the story was very much about corporate social responsibility. Companies had made their commitments post the Paris Accord to meet net zero carbon targets by 2050. Many of those companies were making those pledges to reach that target by 2030 or 2040. Particularly in Europe we've seen this is a strong trend. It was motivated because both employees wanted it but also investors in the companies were looking very strongly at these commitments. This now has an added urgency in Europe because energy prices have gone up, maybe four-fold over the last year, so suddenly it's not just about occupying a building that meets your corporate social responsibility requirements, meets your net zero carbon commitments, but it's also a decision that's now very financially motivated because moving into an energy efficient building can make a substantial reduction to your corporate overheads. I think that's a really interesting additional dimension to this story of moving towards green buildings.

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Bryan Borzykowski: Let's talk more about that. What are companies that are now leasing these buildings really now looking for? You mentioned supply and demand before, I imagine there aren't that many green buildings yet on the market. How does that affect the opportunities and that supply and demand imbalance?

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Kim Politzer: We've been looking at the supply of these green buildings particularly closely. I think we believe that if you want to be in a building that's really going to help you deliver your net zero carbon ambitions then there's probably, in most markets, less than 20% if the stock that meets those requirements. In Europe we have a standard called BREAM, it's a bit like LEED in the U.S. We think you need to be either BREAM excellent or BREAM outstanding to really be on a net zero carbon pathway. That's probably even less than the 20% we're talking about in terms of buildings. Real estate as an industry has been relatively slow to pick up this story. A lot of companies are working through their legacy issues, finally understanding what in their portfolios needs to be done to deliver buildings with a net zero carbon.

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Most companies, if they have been thinking about it, have simply been developing or acquiring new buildings that meet those standards. That's clearly not going to deliver enough supply when many of the companies who've made net zero carbon commitments have made those commitments for 2030 or 2040 rather than 2050. We have really strong demand because companies have made commitments to arriving at net zero carbon by 2030 or 2040 whereas real estate is probably working more to 2040 to 2050. That is an acute supply demand imbalance.

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Bryan Borzykowski: How do you fix that? How do you get more green buildings if it takes so long to build them?

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Kim Politzer: I think the important thing is that we don't want to build new buildings and that's a really important part of this story because it's not simply about having buildings that are energy efficient but the whole process, you need to think about embodied carbon as well. Actually, one of the worst things you can do in many respects is knock down an existing building because there's so much embodied carbon in it and then use a lot of materials that have taken a lot of carbon to create, to build a new building. We think that the important solution is retrofitting and refurbishing existing stock. We think that you can deliver buildings that are on a net zero carbon pathway relatively quickly if you pick the right buildings.

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Realistically, there are some buildings that are in the wrong location, the wrong quality, that will not be suitable for refurbishment and retrofitting but we believe that a lot of the stock, certainly the stock built in the last 20 to 25 years, offers great opportunities to do this refurbishment. What do we mean by that? You pretty much have to remove all the plant and machinery from the building, replace it with more energy efficient plant and electrical equipment. You also have to remove all gas from the building so that's another big project but in doing that, you can actually produce a building relatively quickly that is on the net zero carbon pathway if you've got the right sort of skeleton of the building to start with.

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Bryan Borzykowski: This seems like a lot of work to refurbish. What is the investment opportunity here? Why should investors want to see more refurbished buildings? How does that help them?

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Kim Politzer: I think there's two parts to it. For those investors who have already made their own net zero carbon commitments, clearly, to be invested into this stock which is clearly delivering a positive climate impact will align very well with those ambitions. There's also a financial reward to doing so as well and that comes back to the supply demand imbalance. Given the strength of demand we are seeing that tenants are willing to pay a rent premium for this type of space both in terms of the fact that they want to meet their own net zero carbon commitments but also because it's starting to make financial sense to pay a little bit more in rent to make significant savings on energy.

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The sort of refurbishments we're talking about, reducing primary energy demand which is the key measure that we're looking at in terms of moving to net zero carbon and reducing energy use. In terms of refurbishment I've just described to you we can reduce that primary energy demand by anywhere between 30 and 60%. If you can save almost half your energy bill by moving into a more energy efficient building you can see the logic that you're willing to pay a little bit more rent for it.

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Bryan Borzykowski: So you'll have tenants pay more rent but what about the resale value of the buildings themselves?

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Kim Politzer: Again, what we're seeing is that many investors have also made strong commitments to net zero carbon. For many of those companies that have set very ambitious targets they won't be able to meet them simply by refurbishing their entire portfolio over the next 5 to 10 years. They are going to have to acquire new buildings that already meet those net zero carbon ambitions. We've got a very strong investment market also for these buildings. We're seeing pricing hold up very well for the best quality buildings. Also, we're seeing pricing deteriorate very rapidly for those buildings that have short leases, vacancy, where people are concerned about the capex and they don't feel that they've got the in-house capabilities to deliver that improvement in the building.

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I think what we're going to see over the next couple of years is a real opportunity to buy, I guess, impaired buildings, buildings that need to be refurbished for much lower prices and they're going to be penalized much more in this repricing that we're seeing in Europe than the long leased green buildings that are already in existence. But we're then going to see an opportunity not only to deliver performance from that enhanced rental growth but we're also going to see an opportunity to deliver performance because we know that there's strong investor demand for this product as well. We think that there's a window of opportunity that will give investors enhanced returns. We've been looking at a number of these opportunities and we think we've gone from having confidence that we can deliver a return of perhaps around about the 10% mark a year ago before we saw this pricing correction, to believing that probably those returns are more in the 12 to 14% range now.

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This is a value add strategy but it's not taking a lot of the risk that a traditional value add strategy would take by trying to increase the footprint of the building by adding on floors or expanding the building, intensifying it over the site or anything. This is actually a very simple refurbishment in many ways and therefore it's quite quick to deliver. It doesn't involve a lot of complex planning permission to do these sorts of works and it really starts to deliver the sort of stock that's required into the market, both from an investor and an occupier perspective very quickly.

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Bryan Borzykowski: This sounds like a good opportunity. 2030 is coming fairly quickly, where are we at? Is this the very beginning and how does it ramp up from here?

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Kim Politzer: We are quite early in this. A lot of this is really being driven by regulation and this regulation has been coming in over the last 2 to 3 years. During COVID the EU brought in a fair amount of regulation for post-COVID recovery which was called its Green New Deal. In that they set up something called the EU taxonomy which really drives definitions of sustainable investing, in part to underpin where EU funding would go but also to give investors confidence that when people talked about green investment, sustainable investment, impact investment, that those targets were very clear and they were genuine, they weren't greenwashing. This has really created a very firm foundation in Europe for investing into this sort of product and doing these sort of refurbishments.

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I think we're at the very beginning of it because we now have the regulatory foundation for it. I think it will ramp up over the next few years, in part because we're also going to see a very significant brown discount coming on existing stock that doesn't meet the energy efficient standards that many companies are going to require. I think this is a really key differentiator for what's going on in Europe. I think it will ramp up quickly because of regulation. I think the opportunity is much earlier there in Europe because of this regulation as well.

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Bryan Borzykowski: We've talked broadly about real estate but are there some parts of the commercial real estate sector that are better opportunities than others or does this work kind of across the board?

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Kim Politzer: We believe that offices and industrials are probably the two sectors where it works best. Offices, there's a very obvious link because many office occupiers, their carbon footprint is very much related to two things, their building and their work force travel. If they can move into a building that has really good green credentials, they're dealing with a lot of their carbon footprint very easily. We think there's real logic to improving office buildings from an occupiers perspective. For industrials, it's more about energy efficiency. Industrial buildings very much lend themselves to having solar panels on their roofs and also using things like ground source heat pumps so that you can generate a lot of the electricity that's required by the building from the land and the building itself.

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Given the cost of energy in Europe we think there's going to be increasing demand from occupiers for buildings where energy costs are significantly reduced through self-generation of energy. It's much, much harder in the retail sector. I think that's partly because for retailers, when they're very focused on their sustainability credentials they're much more focused on their supply chain and therefore they're less focused on their property costs and the importance of their property as part of their carbon footprint. We've seen a lot less interest from retailers in driving demand for sustainable premises.

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Bryan Borzykowski: What about geographically within Europe? Are there better opportunities than others inside of Europe?

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Kim Politzer: We believe that these opportunities are very, very focused in the biggest and most liquid markets at the moment, so we think France, Germany, the U.K., the Netherlands are all very attractive. Scandinavians also are very focused on energy efficiency. We think it's harder in southern European markets and also in Central and Eastern European markets. In Central and Eastern Europe the stock is a little bit newer so there's perhaps less opportunity to find the right sort of standard and age of stock to deliver this. I think the cost base is very different of occupancy in some of those markets. In southern Europe the energy costs are slightly differently focused given climate differences. I think it's also a much more cyclical market so supply and demand is a much greater risk for delivering this strategy when you're thinking about value add. We believe that we want to keep the risks to a minimum so we're focusing on markets where we've got good liquidity, we can see strong occupier demand and we can see a good exit into a strong investor demand.

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Bryan Borzykowski: Our viewers today are largely Canadian pension plans and who are probably focused on Canadian real estate, U.S. real estate, why should they care about European real estate?

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Kim Politzer: I think there are probably three or four things that I would focus on. I think if they have a focus on decarbonization then I think Europe is a great opportunity to start practicing that in the real estate environment. I think the repricing of European real estate is giving you great opportunity to come in at very attractive pricing and see a significant uplift as the market recovers in 2024 and beyond. I think currency is a strong player in enhancing those returns for many North American based investors.

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Europe is also traditionally, though I'm talking about a 25% price correction, traditionally a very stable real estate market and it's not very correlated with other regional markets like the North American market or the Asia-Pacific market so it gives good diversification. The income in Continental European real estate is indexed so if we see high inflation persisting then you have the attractiveness of that indexed income coming through so it gives you a bit of inflation protection. Finally, I think there's a real opportunity now to get ahead of the market and getting enhanced returns from following a strategy that looks at delivering decarbonized buildings over the next 3 to 5 years.

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Bryan Borzykowski: Will this brand of refurbishing and what we're talking about, do you think it will come to North America at some point?

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Kim Politzer: I think it will, yes. I think that if governments are serious about delivering net zero carbon by 2050, and most governments have signed up to that commitment, there will eventually have to be regulation that drives the real estate industry to make these changes because real estate is such a big part of the problem. As you said in your introduction, carbon emissions in Europe, 30 to 40% accounted for in the build environment. In city centres that can be 60 to 70%. As an industry we really do need to make commitments to delivering buildings that can help deliver net zero carbon by 2050.

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Bryan Borzykowski: Great. We just have a minute left, how can pension plans take advantage of what we're talking about? As you said, it's still so new, how do they actually invest in this opportunity?

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Kim Politzer: I think you need specialist knowledge. You do need to work with an asset manager who has the experience of doing these sort of refurbishments. It's not difficult but it also need some specialist knowledge, some specialist consultants involved in it and a real focus on actually delivering those sustainability targets. Probably the way through is to invest in funds but you need to make sure that those funds have really strong non-financial targets as well as financial targets to deliver those sustainable goals.

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Bryan Borzykowski: Great. Well, we'll leave it there. Real estate is certainly a fascinating topic that I'm sure we will discuss again soon, especially with all that's going on in the economy and with climate change. Thank you again for joining us.

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Kim Politzer: Thank you.

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Bryan Borzykowski: As always, if you have any suggestions on future topics or guests you'd like to see on the show, please share ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. Thank you. I'm Bryan Borzykowski.