Fidelity Compass

Real Estate – Opportunities and challenges in 2022 and beyond

Kim Politzer, Director of Research, European Real Estate

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Many investors in this environment are seeking out opportunities, offering attractive and stable income returns, diversification and inflation hedging. One asset class that received growing demand amongst institutional investors is direct exposure to real estate. What is the outlook for the real estate sector going into 2022? Why might Europe look attractive on a relative basis and other measures as well? Joining us to share her insights and the factors that drive success when investing in this sector is Director of Research, European Real Estate at Fidelity International, Kim Politzer. Kim has 30 years of experience in the real estate sector and is responsible for developing research, strategy and risk management processes for Fidelity International European real estate funds. She has extensive research experience supporting a wide range of investment styles and strategies in both commercial and alternative real estate sectors. Welcome, Kim. Great to see you.

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Kim Politzer: Thank you, Pamela.

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Pamela Ritchie: Very glad to have you join us here. I'll remind everyone who's joining in in this conversation, in this broadcast, there is a Q&A function on the side of your screen, so go ahead and use that, send questions in and we'll put those to Kim throughout the next 30 minutes or so. Let's begin with a view of what you're seeing in terms of dynamics across the real estate markets themselves, both regionally, and also the sectors within.

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Kim Politzer: I think we've seen a lot of commonalities across the regions over the last 10 years or so, really driven by the weight of capital, so a lot of performance being driven by yield compression. In more recent years, we've definitely seen a lot of interest in what we call in shorthand, bets and sheds, so investors focusing their interest in industrial properties, logistics properties, and residential properties because those sectors have got some strong structural tailwinds that are really helping them to deliver very strong rental growth as well. Those are sectors that are very much expected to outperform. I think things start to get interesting when you look at offices and retail because I think that's where we're really starting to see a strategic asset allocation really playing out. I think over the next few years, that's where it's going to be really interesting to spot winners and losers and really interesting opportunities and where things are going to play out very differently regionally as well.

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Pamela Ritchie: Is the break there, as it is with a lot of life and investment, is the break there, COVID, and perhaps a new interest rate regime that we're entering? How does that fold into the story or is it something else?

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Kim Politzer: COVID has really accelerated the changes that we're seeing in office and retail. Even pre-COVID, both the U.S. and the UK were already seeing some real challenges in the retail sector because of the shift to online shopping. Fundamentally, both countries had too much retail space. It was too expensive for the retailers, so there had to be a real shakeout in that sector. We're starting to see that effect much more broadly than just the UK and the U.S. This shift to online retail, which is really driving demand for logistics space, but also just people's willingness to go into crowded shopping locations, indoor malls post-COVID, it has really waned quite significantly. On the office side, we were seeing a gradual shift working from home, rates of working from home have probably grown about 4% per annum over the decade of the 2010s. But of course, COVID has accelerated that very dramatically. It's not COVID that's caused this disruption, but it's certainly accelerated the disruption.

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Pamela Ritchie: We're going to talk a little bit more about the case, and particularly how you and Fidelity and the work that you're doing sees Europe as perhaps a more attractive real estate market at this moment. Can you just sketch for us what that has to do with the overall investment picture? Why Europe now?

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Kim Politzer: I think there are a number of reasons why Europe and why Europe now. I think one of the really attractive things about Europe is its stability and the amount of performance it delivers from income. Over the very long term, about 70% of performance for core, core plus assets comes from that income pot and that stable income is underpinned firstly by the inflation linkage. Many leases in Europe have inflation linkage built in. At the moment, that's great because we're seeing some unexpected inflation and our income will be protected from that by the fact that we have indexation in many of the leases. We also see it through the planning system in Europe because we have a very structured top-down planning system. We tend not to get big cycles of development in the way that perhaps North American and some Asian markets get. That also creates a little bit more stability in the market and we don't see these big supply and demand cycles that we quite often get in North America, in some of the Australian markets and some of the Asian markets.

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Pamela Ritchie: You don't suddenly just have an increase of hundreds of cranes in the same way that sometimes we do see in other cities.

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Kim Politzer: Exactly. For instance, at the moment, we know that in America, there has been a big development cycle. In places like San Francisco, vacancy rates are in double-digit territory. In Europe, nearly all the markets still have vacancy rates of around about 5 to 7%. We don't have an excess supply, which is causing a downward pressure on rents and that, again, helps provide the stability. It also means that tenants don't move around quite as much, so the probability of the tenant leaving at a break in the lease or at end of a lease is probably a little bit lower in Europe than it is, particularly in North America. That tends to, again, create that stability in the income line for you because they have less options as to where they want to move. If the building's good and the location's good, quite often the tenant is quite sticky in terms of deciding to stay in the building.

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Pamela Ritchie: Tell us a little bit about the work that you do with knowing your occupant. In many cases these are commercial occupants. I suppose any investor, landlord, however you want to look at it, is going to want to know who is occupying their real estate, but describe to us the layers that you go through to make sure the stability continues.

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Kim Politzer: Surprisingly, actually, people probably spend less time thinking about the occupier in the building than they think about the building itself. Yet that occupier is the person who's delivering you that nice, stable income over 5, 10, possibly even 15 years. So, knowing who they are and whether they've got a business model that is going to be sustainable through the entire length of that lease is really important. We've always had a very rigorous due diligence process with our tenants, understanding their financial backgrounds, taking a much more fixed- income approach to looking at that income stream that that tenant's able to produce for us. During COVID, we've really tried to build that out even further. That focus has really proven to be a great value to us. Overall, our rent collection rates throughout COVID have been around about the 90 to 95% mark which is, I think, probably one of the best in the industry because we know our occupiers so well. We've now started to think about them looking forward. We've spent a lot of time looking backwards at their accounts and looking at their financial ratings, their bond ratings and so on, but now we're really working quite closely with our fixed income and equity analysts within Fidelity to really understand business models, outlooks for sectors, so that we can have a high confidence that when we sign a lease with a tenant for 10 years, that we have conviction that they're going to still be there in 10 years' time paying the rent.

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Pamela Ritchie: I wonder if I can ask you to just expand that. There are companies that have not been able to continue existing because of a variety of different reasons. I mean, technological upgrades, even the discussion of whether companies can bear the burdens to invest in themselves to become more climate compliant, are those things that you look at as well?

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Kim Politzer: Very much so. If the equity analyst is looking at them, we want to ask the same sort of questions. They've got a much shorter time frame than us. For us thinking about this, not just, say, for the next 3, 6, 9 months, but we want to think over 5 or 10 years. Is this a business model that's sustainable? Are they thinking about ESG? Have they got good governance processes in place? What evidence do we have that sustainability is at the heart of their business? Is their business at risk of obsolescence because of technological change? All those are really important questions for us. As an example, we acquired a building in the Netherlands at the beginning of this year, which is on a life science park, so it's very much tied into the pharmaceuticals industry. The first thing we did is we started to think about how willing we were to bid for this asset aggressively. It was really to try and understand who the tenants were. One of them was a big Japanese pharmaceuticals company, so we spent a lot of time, first of all, with the fixed-income team, understanding from their pharmaceuticals experience what sort of things we needed to focus on in terms of what pointed to being a robust pharmaceuticals company. Then, we actually spent time with the Japanese analysts, with this Japanese pharmaceuticals company, really understanding the drugs pipeline, what sort of drugs they were, how they developed that drugs pipeline. Through that, we got very, very comfortable that actually they had a very strong outlook, and actually one of the strongest pharmaceuticals companies that we could be looking at. We had high conviction when we were, first of all, bidding on the asset that a 10-year lease with this pharmaceuticals company was going to be very, very attractive, and therefore, we were willing to be quite aggressive. But we also have high confidence that this location and the tenants in this building will deliver a very attractive income return to our clients over the 10 to 15 years that they've signed the lease for.

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Pamela Ritchie: The research and making sure, I wonder if you can explain the degree to which collaboration is part of what you're doing, probably on the ESG front to really understand where tenants want to be, what they desire. Do they want more green space, for instance? Is it different from what it was even two or three years ago, what occupiers are demanding their surroundings to be?

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Kim Politzer: Oh, yes. I think COVID's one of the things that's really accelerated this. There's lots of survey work that's been done over the last 24 months as to what occupiers want. For Europe in particular, that war for talent is becoming a really big issue, as we're starting to see in some countries, the working age population starting to decline over the next two to three years. So, your ability to attract and retain the workforce is becoming much, much more acute in Europe. What we see in surveys is that people want more wellness space. They want more open air space. They want good facilities for coming into work, either by bike or running, so they want showers, they want lockers. All these things are really important, but they also want to see that the building has a high environmental standard. They want to know that the overall carbon footprint of that building is low, the materials have been carefully considered as the building's being built. Particularly, sort of the Gen Z to millennial generations, these things are becoming much more important as people look at who they work for and the values of the companies they work for and the building that you're in is very much part of that identity.

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Pamela Ritchie: Interesting. And so, is it to be looked at as a giant retrofit or is this more on developers building out new buildings, be they office, residential or otherwise? Or is it more of a retrofit?

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Kim Politzer: It's a bit of both. Certainly there's still a call for new buildings that reach those very, very high standards. But of course, what we're seeing is that in demolishing an existing building, you are releasing a lot of carbon. So, the retrofit story is also becoming very, very important, and certainly as part of our thinking around buildings. When we're looking to invest, we're not simply trying to invest in buildings that are already coming with a green certificate. We're looking at buildings and thinking, can we make those buildings more energy efficient? Can we enhance them so they meet the sort of standards of wellness that people are expecting today? Are they in the right location that they're sustainable? In reality, we have to accept that probably 95 to 98% of the buildings that exist in 2050 have already been built today and we need to make sure that they are fit for going forward to hit all the net-zero carbon targets that have been set for 2050.

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Pamela Ritchie: Very interesting. We're looking broadly at Europe, are there regions within Europe that perhaps have governments or regulatory structures that, to you, look more bullish for you to invest in because they've brought in types of regulations or the government just seems particularly focused on these areas?

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Kim Politzer: It's quite early to say that at the moment. What is very clear is that the EU as a whole, as an organization, is very focused on this. We've seen a lot of regulation coming in, such as SFDR, that is really pushing investors to think about these green issues and think about sustainable investing. It hasn't rapidly percolated down to national policy that leads me to say that there's one country that looks way ahead of another, but I think it will be very interesting to watch what happens in Germany, now the new government has been formed and the Green Party is part of that government. I think we can expect to see an acceleration of policies in Germany and a real move in Germany to deliver those green buildings and green standards. Nordic countries are very advanced at thinking about a lot of these issues as well. We're certainly seeing individual policies within the UK that look very environmental friendly. As a very simple example, a couple of weeks ago it was announced that any new housing has to be built with electric car charging points. It's only a little thing but it's a small example of the sort of things that are slowly percolating through into developers, the expectations that are being put on developers to deliver things that are sustainable and thinking about new technology for a greener future.

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Pamela Ritchie: Are there, as you say, green spaces even within a city or an urban place, are those being created? In Toronto, there are some buildings that have a roof garden, for instance, or have created one to create green space. I'm sure there are examples of those, but do you find that goes into the way you look at investments and how buildings need to be built?

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Kim Politzer: Very much so. We're currently undertaking a couple of major refurbishments in Paris. One of the things that we are looking at on those refurbishments is the green space that we can provide. So, we are putting things like green space and roof gardens on those buildings. We are thinking about how we create atrium space with natural ventilation rather than just glassed in. I think that those expectations of open air space are growing significantly, even in cities that have relatively generous green space allowances to have that sort of green space. In the UK, we're putting in an internal green wall in a communal area so you have that green space inside as well as outside. So, there's lots of ways that you can start addressing this and really meet peoples' expectations about wellness, about open space, about the quality of space and the quality of environments.

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Pamela Ritchie: How far ahead would you say are the expectations of those in Europe? I'm not sure to what degree real estate in Toronto and other parts of this country are really actively thinking about the buildings that are going up today having some of these things. Do you have a sense of how much further ahead, for instance, Europe might be?

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Kim Politzer: I think Europe is quite a long way ahead. I was talking at a conference in New York about a month ago, along with another European sustainability expert, and the New York audience that we were talking to, I think was quite taken aback with how much regulation there is within the investment world for real estate and how much expectation there is that funds will have green labels on them now. To have those green labels, you have to start demonstrating that you are thinking about the net-zero carbon pathways for your buildings. How do you make sure that they're not going to be stranded? What are your plans? You may not have to access them today, but we're already having to show that over the next 10 to 15 years, we have a plan. So, some of that plan will be about moving to green sources of energy and that will help. But that's not going to get you all the way. So, you're going to have to start thinking about low energy lighting, movement sensors...

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Pamela Ritchie: That's interesting.

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Kim Politzer: ...grey water for flushing your toilets, things like that. All these things are an important part of thinking how you deliver a much more sustainable building. Because we have so much already in place from a regulatory perspective, very much the investors in Europe are expecting to see this. They're expecting you to be trying to deliver a fund that has very high green credentials, and therefore, to deliver buildings that have a clear pathway towards net zero.

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Pamela Ritchie: To what degree can you charge higher rents now and what do you expect over the next medium term, five years, whatever?

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Kim Politzer: The story at the moment is all about the green premium and that's been the story probably for the last 5 to 10 years. There's been a lot of work done that shows that if you deliver a green building, you get better rents. But that's usually because in delivering a green building, you're delivering a best-in-class building at the same time, so people are willing to pay more because it's a much better-quality building than the surrounding buildings. I think over the next 5 to 10 years, we're going to see a shift in the balance from green premium to brown discounts because we're already seeing, for instance, many of the big brokerage houses employing in their valuation teams people with ESG backgrounds, because they want to understand how much money is going to have to be spent to deliver a building that's going to be net-zero carbon. At what point is that building going to be stranded and how much you're going to have to spend offsetting if it doesn't get to net-zero carbon? That's going to be a drag on value. I think that's going to be a much bigger issue than the premium you get from delivering a green building. So, we need to start thinking about this now and we need to think about what we can do, what we can do in an economically sensitive way because, clearly, we still have a fiduciary responsibility to our investors. We still want to deliver an attractive return to them. We have to get the balance right in terms of the investment that needs to be delivered into the building to deliver an acceptable rate of greening and still deliver an attractive return. It would be very easy to wipe out your returns simply by over specifying, so you have to make sure you've got the right policies in place.

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Pamela Ritchie: This is a question from one of the investors joining us right now. It's pretty much going to what you say but even just more particularly, is there a link between ESG ratings and rent? Does holding a portfolio of highly rated buildings result in increased yield for the portfolio? Is that happening right now? Maybe just more specifics.

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Kim Politzer: I think actually what we're seeing in Europe is less of a push to simply have a portfolio of excellent buildings and actually much more focus on that impact story. Can you actually improve things rather than simply just buy a portfolio of shiny buildings with labels on? Labels are great, they're one part of the story, but actually how the buildings is being used is really important. That comes back, I guess, to the know your occupier thing. If you work well with the tenant and collaborate with the tenants, it's not simply about is the building meeting all these green standards but is the occupier using it in a sustainable way as well? I think all of this is going to be holistically assessed by investors as we go forward. They're not just going to simply say, oh gee, you have lots of buildings with great BREEAM certificates or LEED certificates that say they've been built to very high standards. They're going to want to say, well, how are you making them even better, how are the tenants using them to ensure that they are used to the most effective way?

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I think the important thing is actually that collaboration between the landlord and the tenant to make sure that those buildings really do deliver the net-zero story that we want to see by 2050. So yes, at the moment, if you've got a portfolio of good well-rated buildings and all you've done is buy very good buildings, I think you'll see good performance in terms of capital growth because they should deliver a little bit more rental growth. They'll probably have quite a low yield on them because they will be the most prime buildings in their market, so perhaps you're running return is slightly lower, that income piece, you're much more dependent on the capital growth. But I don't think that's what investors are going to be looking for long term. They're going to look for that whole impact story.

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Pamela Ritchie: Just to go back to what you said about ultimately some of them … it will be almost assumed going forward that buildings do meet various standards and, in fact, it leaves another class of buildings and real estate to a larger degree as stranded assets if they haven't gotten on board on some level. That's fascinating. I feel like that's not even a conversation that's being had really in North America.

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Kim Politzer: I think in Europe our attention has been really focused on it because governments have started to legislate that we have to meet certain minimum energy standards by the end of the decade. At the moment in the UK, for instance, our buildings are rated A to probably F, but you can only lease a building to a tenants if it's rated E or above. By 2027, it has to be rated C or above, and by 2030, it has to be rated B or above. We have eight years to move a whole load of buildings from E to B so that we were allowed to continue to lease them to new tenants. That really focuses your attentions on what you need to do to improve the energy efficiency of buildings. That's a similar story across many parts of Europe.

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Pamela Ritchie: Is there anything, just as we finish up, just to add in on the energy side of things, which must be a piece of the overall story here. It may not be what you focus on, but either the carbon capture or some version of how energy is moving around municipalities to help with buildings, connecting buildings and so on. Is there anything to add to what you're looking at?

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Kim Politzer: There's a couple of interesting things that people are doing, local municipalities are doing. One example in the UK, one area where there are a number of data centres, which have obviously very high energy usage, have a lot of excess heat that they want to pull out of their buildings. The local authority is working with those data centre providers to take that heat and use it for district heating, for local residential areas. There are some quite interesting and creative stories for buildings we really need in the form of data centres, which we know are not very energy friendly in terms of their usage. I guess the other interesting part of the story about being green and having to think about particularly offsetting is that instead of thinking about carbon pricing, we're also thinking about the way that we can do it in-house through investments in natural products that will help our carbon offset. So, investing and planting up new woodland, investing in protecting peatland, which is actually one of the biggest and most important captures of carbon that we have. You don't simply have to pay away money to try to offset the bits of carbon that you can't get to a net-zero pathway. We think it's also important to think about how you can actually contribute. That's the beauty of being a real asset class, that actually owning some woodland or some peatland actually fits very nicely into the asset class as a natural part of your offsetting.

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Pamela Ritchie: Absolutely fascinating to speak with you. Thank you for sharing your thoughts with everyone today and we look forward to seeing you again.

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Kim Politzer: Thank you.

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Pamela Ritchie: Kim Politzer joining us today on Fidelity Compass. Thank you all for joining us today in this conversation. If you have any suggestions for future topics or guests, certainly share those ideas with us. In the meantime, you can stay tuned for more Fidelity Compass websites in the weeks and months ahead. I'm Pamela Ritchie.

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