



# REAL ESTATE ROUNDTABLE

Real estate investing can be an effective hedge against inflation, and subsectors allow pension plans to target exciting niches within the residential, commercial, and industrial markets. We asked six expert panellists to discuss opportunities and risks within this important asset class.

**Six expert panellists discuss opportunities and risks in global real estate investing**



**Samuel Sahn**

Managing partner  
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**Mike Bessell**

European investment strategist and  
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Director, European real estate,  
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**MEET OUR  
EXPERT  
PANELLISTS**



**Corrado Russo**

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**Interest rates are still near historic lows in some markets and at 40-year highs in others. In an uncertain inflationary environment, should plan sponsors be taking a closer look at real estate?**

**Michael Peck:** This has been part of virtually every client conversation we've had in the last six months to a year. Defined benefit plans are susceptible to inflation, regardless of whether or not they link their benefits to an inflation index. One reason is that pension benefits are tied to salary increases, because a lot of the formulas take the best five years or the last five years of earnings, and salaries tend to go up in a higher-inflation environment. Against that backdrop, real estate can deliver consistent real (inflation-adjusted) returns in different rate environments. Our research shows that, since the previous peak of interest rates, quarterly income returns on U.S. real estate have averaged just under 4% annualized, which is really good. More importantly, from a diversification perspective, real estate returns have been



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— Corrado Russo

strongly correlated to inflation relative to other asset classes—and, in a lot of environments, this correlation increases as inflation rises. So, it's a good offset.

opposite directions. If inflation is impacting the growth equation and interest rates are impacting the yield equation, then putting those together creates a smoothing effect. I think it's an opportune time to buy real estate. And, with historically low rates in some markets and 40-year highs in others, it's more important than ever to have a diversified global portfolio.

**Samuel Sahn:** I'd add that the contractual nature of real estate serves as a hedge to rising inflation.

In most lease terms, there are annual contractual rent step-ups built in that mirror inflation. As a result, as inflation rises, building owners can pass through higher expenses in the form of higher rent. That's a meaningful reason for why real estate as an asset class performs well in an inflationary environment.

**Mike Bessell:** As well as being a strong inflation hedge, real estate provides diversification benefits against other asset classes—and it's important to think granularly about real estate, rather than lumping it all together as one single asset class. Whatever happens

to the inflation picture, demand for real estate in specific regions and subsectors remains strong, especially when it's supported by structural tailwinds such as long lead times to construct new assets or a limited amount of space in certain markets. For plan sponsors, using real estate for diversification against other asset classes is a good strategy, and so is diversification within real estate through exposure to various regions and subsectors.



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— Kim Politzer

**Kim Politzer:** For all the reasons others have cited—including diversification of income streams against other asset classes and within the asset class, and the natural inflation hedge that comes with the lease structure—I think real estate has a strong role to play in pension plans. If you already have real estate, hold your nerve. If you don't, given the time it takes to transact, now is a good time to start moving into a market that may see some repricing over the next 12 to 18 months.

**Have recent world events led to niche opportunities within the commercial real estate sector?**

**Bessell:** I don't think COVID created new opportunities, but it accelerated existing trends, such as working from home and online retail. It was also a short-term shock that slightly reversed urbanization and dramatically slowed global travel. But, in most of those instances, we're now bouncing back to pre-COVID trends with, for example, residential rents in places like New York above pre-pandemic levels, and a strong rebound in overnight hotel stays.

**Sahn:** COVID accentuated the attractiveness of data centres and cell towers in the technology space, and U.S. single-family rentals and manufactured housing in the residential space, and it further shone a positive light on the emerging self-storage sector. Senior housing is needs oriented, with defensive characteristics that can grow through volatility in the economic cycle. While there hasn't been a sea change per se, the pandemic opened institutional investors' eyes to these opportunities.

**Russo:** On the private side, nothing really changed. We had a V-shaped recovery in demand for assets and are getting back to normal. But world events created a significant opportunity to buy public real estate at 15%, 20%, or 25% discounts before prices revert to the mean. If there has ever been a time to focus on public real estate, it's now.



**Politzer:** COVID taught us to think more about how occupants use space and, therefore, how critical it is to their business activities. In certain niche sectors, such as life sciences, people need to be physically in a building. (You can't do Biosafety Level 3 laboratory work in your bedroom.) Tenants in those buildings happily paid their rent through the pandemic because the building is fundamental to what they do.

**Are there any particularly promising niche subsectors plan sponsors should know about?**

**Russo:** One neat opportunity that takes advantage of the growth of e-commerce has been to buy older last-mile industrials, fix them up by digging down to increase the ceiling height and pouring reinforced concrete, improve the turning radius for trucks outside the building, and create value in properties seen to be obsolete and abandoned.

**Sahn:** Kim mentioned life sciences. It was a growing sector before COVID, and it has taken five steps forward since the start of the pandemic. These are purpose-built buildings for pharmaceutical and biotech companies benefiting from government, venture capital, endowment, and institutional investment. Meanwhile, hybrid work has caused an explosion in demand for virtual storage space, resulting in global cloud service providers needing more physical space. Combined with the implementation of 5G technology, this is leading to more demand for technology-oriented real estate such as data centres.

**Bessell:** We've been doing a lot of work on medical offices, senior care, and life sciences. Interestingly, in the last six months, we've seen venture capital falling away quite sharply from life sciences, which is a concern. But life sciences can bring about a huge spectrum of opportunities—from a long sale and lease back to a pharmaceutical giant to running what's effectively a WeWork facility with Bunsen burners for people in lab coats. It's the smaller end that's particularly vulnerable when venture capital funding dries up.

**Politzer:** There's an interesting opportunity in data centres, particularly in Europe because of shortages of power on the grid. A lot of underutilized, old, secondary corporate data centres offer huge potential because you can't find the power to build new data centres. But this is not a straightforward real estate play; you need to work in partnership with data centre operators to deliver it.

**Aymeric De Seresin:**

Finding enough opportunities in true niche sectors to deliver meaningful exposure can be challenging. There is simply no secondary market. Either you buy the land and build from scratch, or there is almost no chance to buy this kind of asset. Also, there's the question of whether "life sciences" refers to the tenant or the property. If you buy a warehouse or office building occupied by a pharmaceutical company and the tenant leaves, you don't have a life sciences asset anymore—you have basic logistics or office real estate.



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**Bessell:** These can be very niche markets with thin volumes, and specialized life sciences and data centre funds are driving intense competition for the handful of available assets. That can mean higher pricing than the property's attributes would attract in other parts of the market. These are niche markets for a reason, and they require a specialist's expertise.

**Do you think the trend toward businesses adopting a hybrid workspace model will continue, or will traditional office setups make a comeback?**



**Bessell:** It will vary massively by market. Dynamics are very different in a North American city with long commutes and space at home to set up a permanent workstation versus a much more space-constrained city like Hong Kong or Tokyo, where multiple generations of a family may live in a small residential unit and there's a compelling reason to go back to the office. Dynamics also vary across cultures, industries, and even cities within countries.

**Politzer:** A lot of people were quick to write off the office at the beginning of COVID, but corporates value their office space because it helps create a cohesive workforce and drives synergies from creating together. What's less clear is whether corporates will decide they need less, different, or more flexible space. But we're continuing to see strong demand for the best-quality



office spaces, including green offices and buildings with nice cafeterias, roof gardens, and atria to enhance social interactions. The quality of office spaces is a priority for workers as well, especially younger generations, who consider it when they think about moving jobs or staying in a job.

**De Seresin:** Hybrid work accelerated another trend already in motion before COVID, which is more focus from occupiers on better locations. Everything already established as a strength in terms of location—for example, a good public transportation network and a lively environment to attract young workers—is even more in demand. Now, there are two markets: the winners in prime locations and the losers outside those areas. So, the fundamentals of the market are shifting and portfolios are being reshaped accordingly.

**Bessell:** I agree we're seeing a bifurcation between the best and worst locations, and tenants moving to better locations may take less space but often pay more to have a higher-quality building. Do we need more traditional offices where everyone sits at a designated desk for eight hours a day? Probably not. But do we continue to need a corporate office building used differently, where people split their working week between tasks they do at home and tasks that require interaction? Absolutely.

### Are institutional investors paying too much attention to new builds and overlooking opportunities in renovating existing office buildings?

**De Seresin:** We're about to launch a climate impact solution that emphasizes renovating assets rather than developing brand new buildings. We see that as, by far, the more attractive opportunity. We need to upgrade existing stock because of hybrid working and the changing needs of occupiers. But also, most corporates in Europe are targeting net zero carbon ahead of the legislation, and how will they achieve that if they cannot occupy net zero



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— Michael Peck

carbon real estate? We believe this is the next revolution in our industry: moving the massive amount of existing stock toward net zero carbon, with a continued focus on winning locations.

**Bessell:** The concept of embedded carbon has permeated the real estate industry and is tipping investors

from new builds to renovations. In Europe, we're already used to working with existing structures in the protected centres of cities like London and Paris. We probably still have an underprovision of space that will drive development of new structures, but it's also important to invest in the thought and planning required to renovate existing structures.

**Peck:** Taking an existing asset, refurbishing it, and giving it strong environmental, social, and governance (ESG) credentials does something great for the environment and the city—and also for the bottom line that benefits investors. It can hit plan sponsors' ESG criteria and deliver solid returns.

**Russo:** Work-from-home trends will curb demand over the next five to 10 years, so limiting new supply is better for the industry and for rents. Also, I would love to see North America have more heritage buildings that last so our kids can enjoy buildings with history and character.

### What about retail real estate, which was already in a tough spot before the pandemic?

**Russo:** "Retail" is a very broad term that includes superregional fashion-oriented malls, regional malls focused on entertainment or services, grocery-anchored shopping centres, outlet centres, and street retail. Each has different dynamics. Superregional fashion-oriented malls were already in decline pre-COVID. COVID accelerated that decline, and I think they'll continue to suffer. Some landlords repositioned pre-COVID, but many became entertainment venues and were hit hard by COVID. On the flip side, everyone loves grocery-anchored shopping centres. Pre-COVID, they provided stable income. In COVID, they demonstrated their resiliency. Demand will remain, especially because this asset class provides some inflation protection. Overall, it's going to be about how retailers reinvent themselves.

**Sahn:** The pandemic really turned retail around. In the five years leading up to the pandemic, retail was experiencing a secular decline as retailers around the world were not reinvesting in their own businesses. Overnight, the pandemic forced retailers to change, investing in operations, technology, and delivery systems just to survive the next few months. Overleveraged retailers were pushed into bankruptcy, but the strong survived, thrived, and gained market share. Those able to successfully navigate the pandemic could think about opening new stores and concepts to take advantage of vacancies and lower rents in the best centres. We think retail real estate is on a stronger footing today than it was pre-pandemic, with retail spending at, or above, pre-COVID levels in most markets. Necessity-based retail, in particular, is thriving. Also, globally, hardly any new supply of retail centres is being developed.



**Politzer:** We were skeptical about retail from 2017 onward. I agree, it's looking more attractive, but investors need to make sure an asset has been properly repriced to reflect lower rents. Also, retailers still face challenges, given talk about a recession and slowing consumer sentiment indexes across Europe and now in America. That said, retail is the glue that holds communities together. For some niche investors, there may be an opportunity to deliver the "S" in ESG by partnering with local governments to deliver community retail.

**We hear a lot about investments in digital sales fulfillment centres. Could this be a bubble?**

**Sahn:** In my view, it isn't a bubble. Market rents continue to rise because demand for industrial space that caters to e-commerce is strong. In fact, e-commerce retailers need an average of three times as much space as bricks-and-mortar retailers. They also need to be



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**Politzer:** It's definitely not a bubble. There was a huge reaction earlier this year when Amazon announced they weren't going to need more space, and that, in fact, they were going to sublet space. But if you look at projections for online sales, by the end of 2023 or early 2024, we're expected to be back at peak levels reached in 2020 and 2021 in lockdown. So, this is a

in last-mile locations to compete with Amazon's same-day or next-day delivery. Prologis, the largest owner of industrial facilities in the world, has market embedded in its portfolio approaching 50%. I don't think that's a referendum on the value of traditional shopping centres—there's room for both—but there's clearly robust demand for industrial facilities.

pause rather than a radical reshaping of the industry. Companies took on space to deal with a huge surge in demand. That's fallen back. But in a couple of years, we'll be back at those levels of demand. Their space is going to be full, and they're going to be looking for more space again. Reinforcing that is the transition from "just in time" to "just in case" inventory because of supply chain disruptions. That said, some that bought in the last 12 to 18 months overpaid for the risks they're taking in the sector. There will be lessons learned from that, particularly in Europe, where we're already seeing softening yields in the industrial logistics sector.

**Bessell:** Estimates indicate that parcel delivery costs are about 10% of the e-commerce value chain, and last-mile delivery costs make up about half of that. So, a more efficient distribution centre offers direct profitability gains to the retailer. Some irrational exuberance may come from an assumption that, if Amazon can pay four times the going rate on a logistics facility, then everyone else will, too. But when we strip out those one-offs, the rest is well underpinned because it's so tightly connected to profitability.

**De Seresin:** Another strong fundamental that suggests the trend will continue in Western Europe, specifically, is the lack of warehouse stock—and it will be hard to grow that stock because it's very difficult to get planning approval to build new warehouses in Europe. This will help rental growth in this category and increase the capital value of existing stock for years to come.

**What advice do you have for plan sponsors that are concerned about liquidity in real estate investing?**

**Peck:** The liquidity question isn't just a real estate question; it's applicable to all private market investments. But remember, illiquidity is a premium source of returns; you accept illiquidity with the expectation that you'll be compensated for it in the long run. That said, plan sponsors need to look carefully at their overall liquidity needs as they increase allocations to private markets in general. And, there's a continuum of liquidity in real estate from open-end real estate funds to closed-end real estate funds all the way to direct investment in



properties. If liquidity is a concern, stick to core, big liquid markets.

**Russo:** I agree—and remember, if it's okay for your plan to take illiquidity risk in real estate because you're a long-term investor with a 10- or 20-year horizon, you also have time to ride out volatility. If you look at the average rolling 10-year returns of real estate investment trusts (REITs) versus private real estate, you get to the same place—but having public and private in your real estate portfolio helps balance liquidity and volatility. Also, when an asset class collapses—as equities did this year—liquidity in a component of your real estate portfolio allows you to reset and maintain an appropriate asset allocation for your plan.

**Many large public sector pension plans are investing in making properties more sustainable. Is this an effective strategy for raising portfolios' values?**

**Bessell:** This is rapidly transitioning to a defensive strategy to protect portfolio values. We're moving from a green premium to a brown discount, particularly in Europe, where we're seeing increasing stringency on the energy performance certification you need to lease a building.

**De Seresin:** Most investors, including us, are starting to discount any future risk of capital expenditure improvements. We have to figure out when an asset will be stranded in terms of CO<sup>2</sup> emissions. The spread in value will widen rapidly, so



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our strategy is to maintain our properties to the highest level of sustainability. Soon, there will be many assets in need of quick refurbishment, and a lot of players in the market won't be able to do this. We'll happily take that asset and do what needs to be done.

**Politzer:** All the big valuation houses are employing ESG specialists to ensure they're incorporating the green premium or brown discount into valuations and properly capturing how much it will cost to bring assets up to standard. The other point is, it's not just about delivering performance; it's about attracting new investors—in particular, millennials.





**Overall, what's your biggest piece of advice for plan sponsors investing in real estate in the 2020s?**

**Russo:** Specialty subsectors—such as data centres, life sciences, and self-storage—need to become part of your core plan. Also, there are four real estate quadrants: private equity, private debt, public equity, and public debt. A balanced strategy can take advantage of inefficiently priced quadrants at any point in the cycle while addressing risk, liquidity, income, capital appreciation, and inflation protection simultaneously.

**Sahn:** There has been a proliferation of new company and fund formation in the private world, and there's about \$350 billion in private capital on the sidelines waiting to invest in commercial and residential real estate around the world.

The next decade will be about identifying long-term demand and supply trends in all the investable subsectors, and finding the best global opportunities for risk-adjusted growth.

**Peck:** To mitigate risk, plan sponsors need to partner with an experienced manager. Real estate investing is complex. You have to do the transaction analytics, get proper valuations, have a closing and due diligence team, and know asset managers have a plan to grow the building's revenue stream. Choose a manager that understands tax considerations when buying global real estate and has boots on the ground—because real estate is a local business. Also, don't lose sight of why real estate is in your pension fund portfolio, whether it's as a source of income, capital appreciation, or inflation hedging.

**De Seresin:** Yes, look at a manager's presence and knowledge. Across our portfolio, we collected 97% of total rents during COVID because we have asset managers speaking to tenants in every country where we invest, and we understand and underwrite risk.

**Bessell:** We're in a stock-picking market. There are winners and losers in each sector, and that makes it critical to have managers with intense local knowledge that can find niche opportunities and maximize value.

**Politzer:** Diversify globally and choose managers that have delivered stable income returns through active asset selection and management despite all the disruptions of the last five to seven years. Sustainability will be a big theme over the next 10 years as plans put in place their own net zero carbon targets. Plan sponsors should challenge managers to help them deliver those targets.



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