ROUNDTABLE

Global positioning

Some of the planet's biggest investors discuss strategies for extracting maximum performance from real estate as the pandemic continues. By Stuart Watson

As the picture of a market shaped by covid continues to emerge, *PERE* and co-host Macquarie Asset Management gather together some of the world's leading real estate investors for a special roundtable. The agenda for discussion: to identify the priorities for the big pools of capital at this point in the pandemic, as they face growing challenges in their existing portfolios, and to confer on how best to drive returns in a market that is becoming ever more complex to navigate.

Brett Robson, global head of real estate at Macquarie Asset Management, the asset management arm of Australian-headquartered global financial services group Macquarie, kicks off the roundtable by observing that while transaction volumes have declined globally since the onset of the pandemic, it has nonetheless been surprising how much business has been conducted. He attributes the market's resilience to the growth and globalization of capital.

"The big investors have gotten bigger and more sophisticated, and therefore they have had the resources, scale, knowledge and partners in place to enable them to respond through the pandemic," he says.

GIC still considers itself underinvested in real estate and has stepped up its activity in the sector, aided by a diverse set of local partners. Maintaining momentum has required depth in individual markets as well as global breadth, notes Sunny Tsun, head of Australian real estate at the Singaporean sovereign wealth fund.

"We have many established, market leading partners that we work closely with across key markets," he says. "Despite the travel restrictions during the pandemic, our 'boots on the ground' in our local offices in the US, Europe, and quite a few Asian countries, have allowed us to continue pursuing deals without being too hampered."

Moreover, having a network of local offices rather than a centralized model has supported portfolio management, adds Christoph Donner, US chief executive officer at Allianz Real Estate. "Your local team can assess the situation pretty quickly. In our case, with the exception of certain sectors like retail, our portfolios have held up well. Once you give that message back to the investors, the doors remain open for new business with them."

Cap rate compression ends

The big players have continued to commit capital to real estate through the pandemic, but can they rely on the asset class to provide the performance needed to meet their liabilities?

Relative returns in the asset class still appear attractive, suggests Tsun. "Even through covid, real estate has continued to generate a relatively good income yield. We saw some volatility for a short time, but we think that was largely a blip," he says.

"Secondly, it has a relatively low correlation with other asset classes, and it also possesses some elements of inflation hedging. Therefore, real estate will likely remain an important asset class for us."

That returns have declined in absolute terms is clear, however, adds

Sunny Tsun

Head of Australia, real estate
GIC
Tsun has been with GIC for 20 years, managing real estate portfolios across markets including Europe, China, Southeast Asia and Australia. The Singapore-headquartered fund is one of the largest sovereign wealth investors in the world. Tsun previously worked at SEB Investments and Ping An Trust and Investments.

Florian Winkle

Senior managing director, co-head of Europe, real estate
Macquarie Asset Management
Winkle oversees Macquarie's business development, portfolio management and operational activities in Europe. He was previously managing director at GLL Real Estate Partners, which was acquired by Macquarie in 2018, and led the Munich-based manager's new product development and capital-raising capabilities.

Stéphane Jalbert

Managing director, head of Asia-Pacific and Europe, real estate investments
PSP Investments
Since joining PSP Investments in 2009, London-based Jalbert has been instrumental in the development and growth of PSP's global real estate portfolio. The firm is one of Canada's largest pension investment managers, with $204.5 billion in assets under management, around 13 percent of which is in real estate.

Brett Robson

Senior managing director, global head of real estate
Macquarie Asset Management
Robson has over 30 years' experience including 18 in asset management and corporate finance with Macquarie. He leads Macquarie Asset Management Real Estate and the firm's global real estate funds and asset management business, overseeing a team of more than 200 professionals in 29 locations, managing A$19 billion ($14 billion; €12 billion) of assets.

Christoph Donner

Chief executive officer, US
Allianz Real Estate
Donner leads Allianz Real Estate's US business as well as sitting on the firm's executive committee. The real estate arm of the German-headquartered multinational insurance business manages assets totaling €74.3 billion, with its US business accounting for $13.9 billion of debt investments and $7.8 billion in equity.

Climate codes in focus

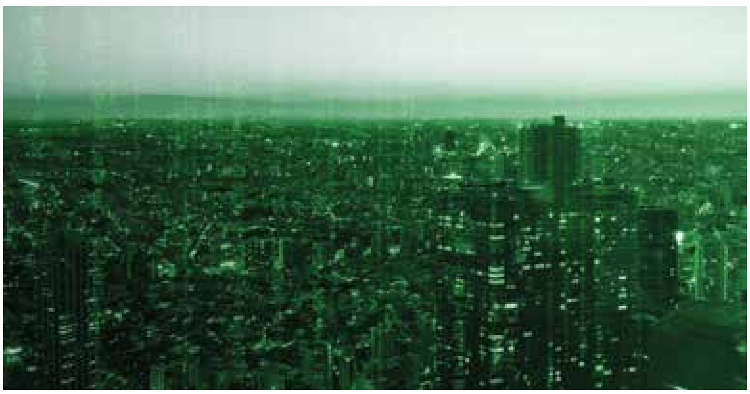
The move to net-zero was a major talking point in the discussion. *PERE* summarizes the participants' high-level decarbonization policies

Macquarie Asset Management: In December 2020, Macquarie Asset Management announced a commitment to invest and manage its portfolio in line with global net-zero emissions by 2040. It is already measuring greenhouse gas emissions at its private portfolio companies, and will identify pathways to reduce emissions and work with each company to produce Paris-aligned business plans by the end of 2022.

GIC: A target to become carbon-neutral in the business's own operations was met in the 2020-21 financial year. The investor takes "a holistic and long-term approach toward sustainability across our investment and corporate processes," arguing that investments may entail trade-offs between different sustainability objectives, especially in the shorter term and in emerging markets.

Allianz Real Estate: Allianz has targeted a reduction in the greenhouse gas emissions of its real estate portfolio to net-zero by 2050, and has set a preliminary objective of reducing the carbon footprint of its global portfolio by 25 percent by 2025, with a structured framework in place to reach the milestone.

PSP: The Canadian investor's strategy encompasses the integration of climate change factors into investment decisions at the total portfolio, asset class and individual asset level; monitoring of the portfolio's exposure to climate change; and engagement with portfolio companies for better climate change-related financial risk disclosures, including support for the Task Force on Climate-related Financial Disclosures.



Stéphane Jalbert, managing director for real estate investments in Europe and Asia-Pacific at Canadian pension fund manager PSP Investments. The assertion is borne out by MSCI figures, which show that returns for all property assets fell from 6.8 percent in 2019 to 2.4 percent in 2020. "Interest rates have stayed low for a long time and we have been used to cap-rate compression, but yields have already reached their lowest point, so we will not see that in future."

The key to making the right acquisitions during the pandemic is to differentiate assets that have been affected by cyclical trends from those influenced by structural ones, Jalbert argues. "Where we are going to get returns is to grow cashflow by investing more into sectors that are backed by secular trend shifts, more into operational cashflow-oriented real estate, and by using green technology to make buildings more efficient, retain tenants and grow rents."

For Florian Winkle, Macquarie Asset Management's co-head of European real estate, the crucial investing themes of today are: "Beds, sheds, bytes and desks." He says: "We expect that the residential sector will see a significant increase in demand, as will logistics. Data centers are becoming ever more important, and we believe that people will want to come back to the office. As always, successful investing is about the location and quality of the real estate. But increasingly it is also about providing flexibility, and not only in the office space."

New economy sectors

The challenge in two main asset classes, logistics and residential, is that competition has already sharpened prices, says Donner: "Yields are at a level where they may not be as attractive going forward, so to look for yield and investment opportunities, investors will have to continue to pivot into emerging asset classes like student housing, but then beyond that into sectors like manufactured homes and life sciences."

However, he admits that establishing a large portfolio in a niche segment

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>
> **SUNNY TSUN**
> **GIC**

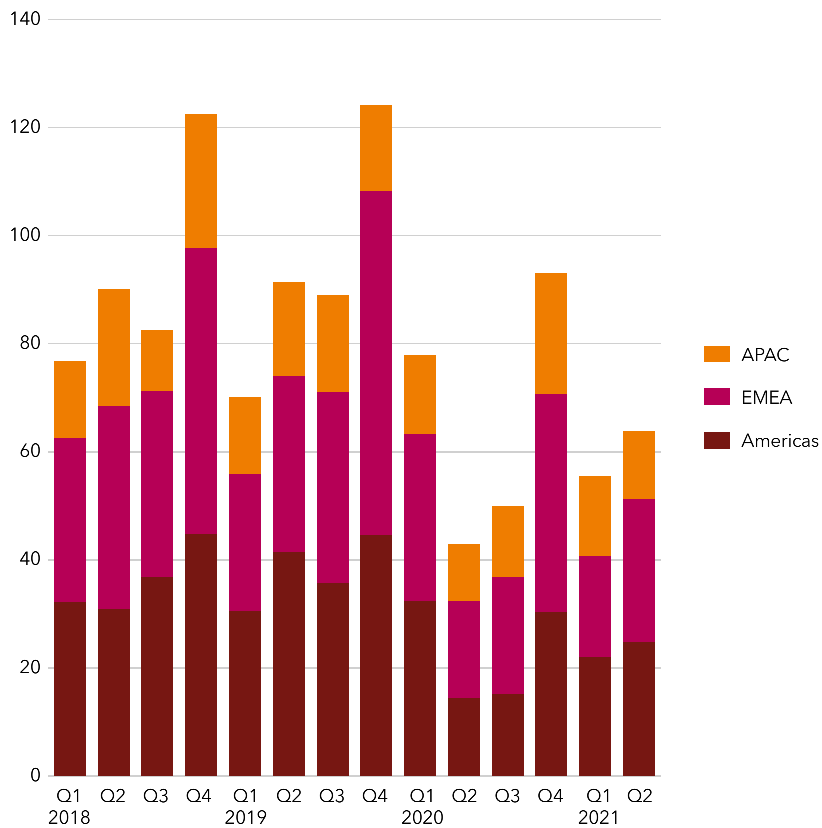
is often arduous work: "Those will largely be add-on strategies, because it is going to take a while to get exposure to a level that is comparable to the main asset classes."

Establishing joint ventures helps when seeking to pivot to new economy real estate at scale, suggests Tsun: "In certain sectors, like data centers, we are seeing huge growth. We find it is very important to get on the right platform, working with the right partner, to be able to scale up quickly. For example, we have a big partnership with Equinix to provide hyperscale data centers."

Development constitutes a crucial component of expansion into alternative asset classes, notes Robson: "We see one of the best ways to be able to grow your exposure to new economy sectors is to partner or participate in the operating platforms, with the creators of the assets."

Robson says such an approach is easier for large investors: "The biggest investors had the capital and the resources to pivot early into sectors like logistics and purpose-built rental housing and establish platforms. When

Office investment is below pre-pandemic levels, reflecting uncertainty over the future of the asset class ($bn)



Source: CBRE

Talking shop

Allianz and PSP executives consider the plight of shopping malls and high streets

Donner: About 16 percent of our assets globally are in retail. There are big differences between countries in the structure of their retail markets and consumer behavior. It can be hard to make a case for retail, except that my teenage daughter and her friends still love to go to the mall. The malls that have a future will be marketplaces where people meet and hang out. In the US, we are seeing physical retailers like Target and Walmart achieve some success integrating stores and internet platforms to enable them to compete with the likes of Amazon. There will also be a future for the high street as more and more people return to cities after the pandemic.

Jalbert: Historically, investors bought retail because it was a good proxy for consumption and provided inflation-linked income. The problem in the US is that too much was built and shopping centers became too commodity-driven, so when e-commerce appeared, stores were selling too many commoditized products without offering enough services, entertainment, and food and beverage. There is still an opportunity for the better malls that act as town centers to be rethought. But a price correction needs to happen first, which will hurt lenders. And owners will need to diversify and invest capex into adding more residential, clinics and lifestyle-related tenants.

covid accelerated demand in those sectors, they were able to scale up and recalibrate their portfolios toward sectors that they believed were going to deliver more sustainable, long-term income growth."

Investing into new economy sectors requires a shift in asset management approach, argues Jalbert: "When you tap a sector where the demand is ever growing, where there's an opportunity to aggregate, to manage in a more institutional way, there is a real benefit. But you need to acknowledge it's a bit more private equity-type investing as well. There's a commercial component. It is more about attracting customers to your real estate."

Discovery territory

Beds, sheds and bytes are currently indisputable winners in pandemic real estate, but desks are still the subject of heated debate. The conundrum of the future of offices as an asset class dominates the middle of the discussion. Global investment volumes demonstrate the nervousness that many investors feel about the sector. CBRE research calculates that during the second quarter of 2021, the level of transactions recovered to $63.7 billion from the covid-hit Q2 2020 figure of $42.8 billion. But while that represented a rally, market activity was still well below the $91.2 billion recorded in Q2 2019.

That prime, long-leased buildings are still in demand in a real estate market focused on preserving income is perhaps unsurprising. But the market is still in discovery territory when it comes to the rest of the office stock.

"Buildings with longer leases are doing well because investors like us are pricing the security of income," says Macquarie Asset Management's Robson. "We are not seeing a major repricing in global direct office markets, which is interesting, because if you look at the listed market, which usually leads the direct market with lower volatility, despite some recovery from late 2020, US office REITs are currently trading at around a 27 percent discount to NAV.

"It is likely that uncertainty and a shorter-term low-income growth outlook is driving the listed pricing, and the market is discounting all office assets rather than just shorter-leased, older, low sustainability and amenity product."

There is a school of thought that suggests that as higher levels of flexible working reduce overall demand there will be a flight to quality and a bifurcation between the best buildings, for which prices will hold up, and lower quality space, which will be discounted. However, that course of events is far from certain given the weight of money seeking value-add opportunities, says Jalbert.

"If a bad asset is discounted by 15-25

"Investing is about the location and quality of the real estate. But increasingly it is also about providing flexibility"

FLORIAN WINKLE
Macquarie Asset Management

"We have been used to cap rate compression, but yields have already reached their lowest point"

STÉPHANE JALBERT
PSP Investments

percent gross asset value, that allows a smart investor to put new capital in and then have a yield on cost that translates into a reasonable rent," he adds. "Then a tenant will have a choice between a high-quality building or a newly refurbished one that slightly undercuts the market, and that may bring a price adjustment for the whole market."

The degree to which working behaviors will change also remains uncertain. Tsun believes it will vary across different geographic markets.

"Denser cities, for instance, are less well positioned to support work from home as the mainstream form of work for the long term due to smaller apartment sizes, than cities with bigger and more affordable suburbs with good communication and transportation links, like in the US," he says. "And in the fast-growing emerging markets of China and Asia, a new generation of offices is still being built, so those markets may have more opportunity to adjust to the new way of working and achieve equilibrium in terms of supply."

When the pandemic is under control and workers return, cities like London, Paris, New York and San Francisco will remain popular with office occupiers, predicts Allianz's Donner, but lease structures will need to change to accommodate more flexible working practices and get people back to the office.

"We will not be going back to the 'old normal'," he says. "Office leases are going to be shorter than they were in the past and will not justify high levels of tenant improvements. There needs to be a conversation with lenders about that, but you will no longer have long-term office leases that can be treated as a passive investment."

Obsolete office buildings will provide opportunities for repurposing, but that is not a new phenomenon, notes Winkle: "We saw a lot of conversions from class C and D office buildings into residential in the early 2000s. We believe people will want to come back to the office, they want to collaborate, they want to talk to each other, but you have to create the right experience for them. We have seen user and tenant experience become more important in shopping, in residential and now we are seeing it in offices too."

Robson adds: "Covid has acted as an accelerator for a structural trend in the office market toward better quality space, with more services, that is much more sustainable and serves the well-ness needs of the occupiers. Anecdotal evidence suggests that where companies already have highly sustainable, new economy-type buildings, their staff seem quite happy to get back to the office."

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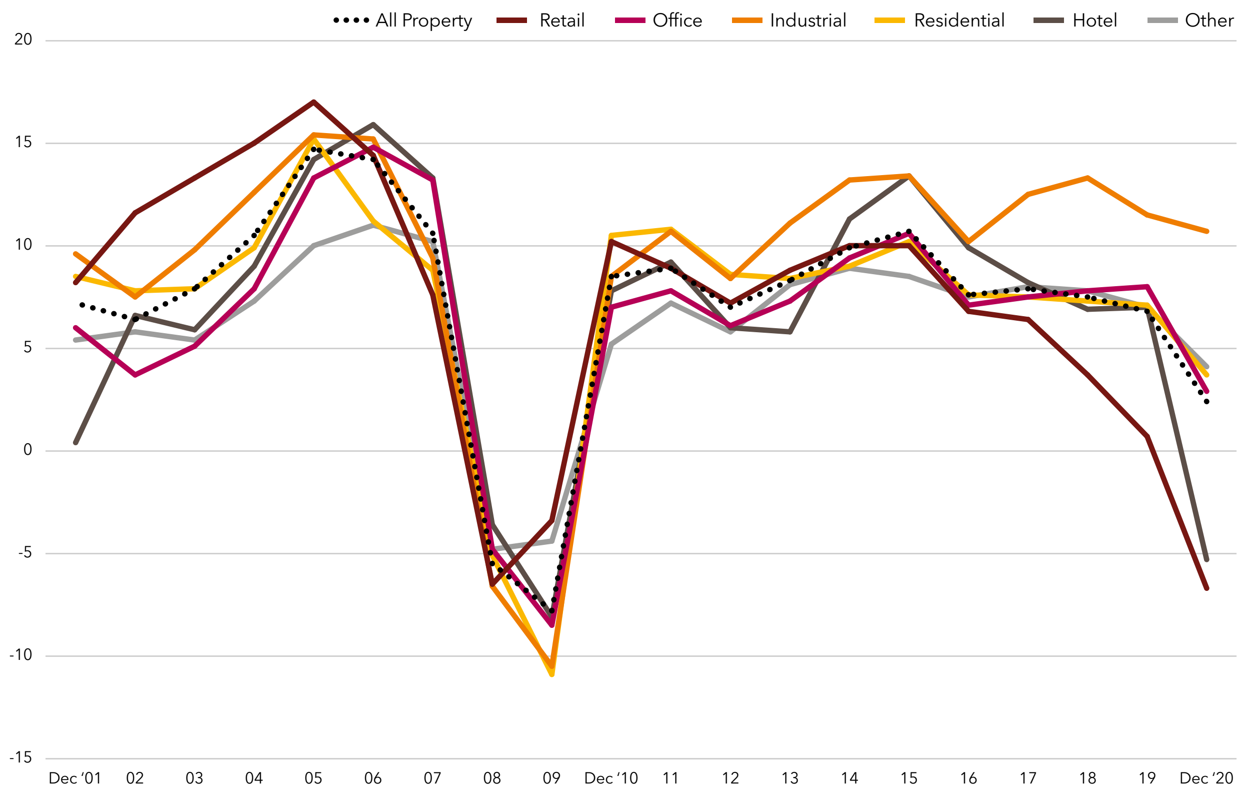
BRETT ROBSON
Macquarie Asset Management

Global annual returns in 2020 showed the uneven impact the pandemic had on performance across sectors (%)



Source: MSCI

> *"We are not making any investments... if there is not a clear path to carbon neutrality"*
>
> **CHRISTOPH DONNER**
> **Allianz Real Estate**

Focus on decarbonization

The participants agree that not only in offices, but in all other sectors of the market, action on sustainability and decarbonization is now a vital component in asset selection and performance.

"At Allianz, the implementation of these policies is almost ferocious," says Donner. "Acquisition teams across the globe are becoming engineers and experts on carbon emission and carbon neutrality. Europe clearly is ahead in this area. However, with the ongoing series of climate-related events, the US is catching up quickly. We are very clear we are not making any investments, and there are no exceptions, if there is not a clear path to carbon neutrality with the capital and the necessary steps already identified to get there."

Donner dismisses the idea of 'greenwashing' assets through carbon offsetting: "We are truly looking at the underlying asset and making each compliant. The big hurdle is getting the right data at investor, partners and tenant levels."

Both Macquarie Asset Management and Allianz have committed to net-zero carbon targets, by 2040 and 2050 respectively.

"This is now a fundamental part of execution," insists Robson. "It will be a differentiator and we believe can help drive investment performance. There is an adjustment period where the industry is recalibrating how it thinks about this.

"And it is not only important for investors, underlying users, and the community that is served by the assets which we manage, but also to your own teams internally. We are finding that in terms of attracting and retaining talent, people want to work in organizations that have a very proactive and positive approach to ESG more broadly, but in particular to net-zero."

"This is the way we do business now because the climate threat is real," adds Jalbert. "For us, the marketability for financing the asset, for attracting tenants, for finding a buyer means you need to be as green as possible."

Significant capital expenditure will be required to improve low-performing buildings. But that could very soon represent a "huge opportunity" for value-add office investing, he says: "There is constant demand for office tenants to do the right thing, to be in efficient buildings that are powered by renewable energy, and have a sustainable impact on the local communities."

Transformational change cannot be achieved overnight, cautions Tsun: "The key assessment for us is whether the asset can be improved over time, even if the starting point is not great. In some areas, new solutions are still emerging and real estate is a long-term investment, so we need to be mindful of how we can work with partners to implement change over the whole life cycle of the asset."

The "elephant in the room" is that much of the discussion around carbon neutrality has centered on building operations, while 60-80 percent of emissions are embodied in the structure of the building itself, cautions Robson.

He believes that progress is being made: "We are seeing tenants support looking at how we deal with the embodied carbon element, whether it's through cross-laminated timber construction or sophisticated materials recycling.

"And permitting bodies are showing that they are prepared to give more planning rights for buildings with lower embodied carbon. That provides a real financial logic for it."

From identifying structural trends amid the fallout of the pandemic, to selecting sustainable building materials, the backdrop for real estate investing has perhaps never been so complex. But the sector's largest and most sophisticated investors make a strong argument that their breadth of experience and depth of capital resources will continue to make them well-positioned to seize opportunities as they emerge. ■