Office challenges and opportunities in a more difficult market

In September, Tell Media Group, in cooperation with **JPMorgan Asset Management**, **Nuveen** and **Principal Asset Management**, organised a roundtable discussion at Hotel d'Angleterre in Copenhagen focusing on real estate investments. Tell Media Group founder Niklas Tell and Nordic Fund Selection Journal editor Caroline Liinanki moderated the discussion.

By: Niklas Tell Photo: Christer Salling

The discussion started out with Caroline Liinanki pointing out that real estate has been an asset class that has been performing very well for a long time but asking how concerned real investors should be at the moment in light of all the uncertainties.

MICHAEL NEAL: "It's interesting what you say about real estate having done well for a long time, which it did along with a lot of other asset classes. We got used to low interest rates and the cost of debt was helpful for real estate and investors were also looking to real estate to get the returns they didn't get in fixed income. People almost forgot that real estate is cyclical. What we've been through now is a significant increase in interest rates and the cost of capital together with structural change in the market. That, of course, changes everything and it's something that we were used to seeing some 10 to 15 years ago but got used to a market driven by monetary stimulus. It has an impact short term and it will be an adjustment phase to get relative values to where they should be. We're a long way through that but we're not done."

PAUL KENNEDY: "I would just like to expand on what Michael said about investors going through a period with exceptionally low bond yields. Yes, it did lead investors to look to real estate to get the income they didn't get from fixed income and that trend is now reversing when you do get an income from bonds. However, we need to remember that during this period, more investors have got used to and have got experience from a range of private market investments that they didn't have before. That does not go away. Also, I think it's important to look at the long-term trend of bond yields. We got very low bond yields following the global financial crisis and that has now reversed but the long-term trend of bond yields is that they are likely to remain relatively low."

NIKLAS TELL: WHAT DOES THIS MEAN FOR THE ALLOCATION TO REAL ESTATE? SHOULD YOU HAVE MORE ALLOCATED TO REAL ESTATE THAN PRIOR TO THE FINANCIAL CRISIS BUT MAYBE LESS THAN WHEN INTEREST RATES WERE ZERO?

PAUL KENNEDY: "Yes. That would be my conclusion. One of the constraints when it comes to allocating to private markets is that they're difficult for a range of reasons. It requires a different skillset and on top of that, it's also more difficult to invest a billion in real estate than a billion in bonds or equities. However, once investors have that structure in place and once they're used to investing in these asset classes, they will continue thanks to the diversification and alpha benefits."

RUSSELL A. BEECHER: "I would agree with that. What you said about the acceptance of the asset class is valid and I think that's here to stay. Also, even if the income part of real estate has lost some of it's benefits with higher interest rates, I think your alpha comment is an important one. I think we're in a good position right now for those looking to continue to invest and generate alpha."

NIKLAS TELL: I WOULD LIKE TO COME BACK TO CAROLINES ORIGINAL QUESTION ON HOW WORRIED REAL ESTATE INVESTORS SHOULD BE RIGHT NOW.

MICHAEL NEAL: "There are a lot of uncertainties today, which means reduced liquidity and elevated risk premiums. But I would argue that we see opportunities today. Not across all of real estate but we're starting to see deals with very attractive characteristics. It's also important to remember that when sentiment changes, it changes quickly. I therefore think it's important for investors to ensure that they're ready to invest, even if they're not ready to deploy capital today. In order to have the optionality to invest, they should be looking to build relationships and raise the capital to ensure they have resources and relationships in place for future deployment."

RUSSELL A. BEECHER: "I agree. The window will close quickly and there are already opportunistic returns to be had today. If we look at the US market specifically, with USD 1.9 trillion of debt maturing over the next three years, and a high percentage of that floating rate, I think we will see increased stress within the capital stack resulting in a lot of opportunities. I also think that the concern over the US REIT market is overdone and that it's well positioned to generate strong returns when sentiment changes."

LAURA ROBIN: "I think Paul's comment that investors used to look to real estate to replace fixed income is a valid one. However, what I hear now is if we haven't invested in real estate, why should we start now that we actually receive an income from fixed income? I do think we will see a re-pricing and that there will be opportunities to build an exposure to real estate next year. I therefore want to be flexible in my fixed income allocation to be able to use some of that if we see opportunities in real estate in the next six to nine months."

PAUL KENNEDY: "I think that's wise. The timing is important simply because transaction costs are high in real estate so you need to be sure that it's the right time to deploy capital. That said, we're seeing clear opportunities for investors going forward and we expect the window to remain open through 2024 and, potentially, into 2025."

RUSSELL A. BEECHER: "We think the best value in the short term continues to be in real estate debt. That being said, we think we will see a new real estate cycle in the middle of next year and those with capital to deploy will then be able to take advantage of better relative prices for real estate."

CAROLINE LIINANKI: LAURA, WHAT IS YOUR CURRENT ALLOCATION TO REAL ESTATE AND YOUR THINKING GOING FORWARD?

LAURA ROBIN: "We have three different portfolios where two have a fairly short horizon but we do have a long-term

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LAURA ROBIN
Working within the United Nations Office for Project Services (UNOPS) treasury team specialising in investment management, which she joined in 2017. Prior to this, she spent 10 years advising clients as a vice president at J.P. Morgan Asset Management in London and as an analyst within the private wealth management division of Morgan Stanley in London.

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Managing director, acquisitions/dispositions at Principal Real Estate. He is responsible for overseeing investment activities in the Western half of the United States. He has worked in the real estate industry for over 30 years including over 22 years with Principal. He has also overseen acquisitions for The Shidler Group as well as Pacific Office Properties Trust and was a broker for Eastdil Secured.

portfolio where we have an allocation to US REITs. We regularly do asset liability management studies and each time it says that we should invest in infrastructure, timberland etc but the portfolio is too small to have enough allocation to each of these asset classes. We're also discussing with other UN agencies if we should be moving together on this."

NIKLAS TELL: WHAT DO YOU THINK INVESTORS SHOULD DO WITH THEIR CURRENT REAL ESTATE ALLOCATIONS?

MICHAEL NEAL: "I would focus on the controllables, asset management in particular. It's about managing your exposure with the aim of having quality for the medium and long term. If you don't need to sell, you may wish to hold but bear in mind that if you can make sales, it provides a good opportunity for capital recycling into assets with better long-term fundamentals."

PAUL KENNEDY: "We're seeing tentative signs that some investors are starting to see attractive prospective returns from real estate compared to other asset classes. But there's clear nervousness in the acquisition market today when it comes to where bond yields will settle and as well as rental growth potential. However, this environment is creating positive conditions for investors that are willing to take a view on occupier fundamentals and bond yields."

RUSSELL A. BEECHER: "This also relates to the underwriting and how that has changed. Now we're seeing the type of underwriting that we typically see in recessions. It's very conservative assumptions setting the stage for outperformance. We've been defensive for a while but we do see opportunities on the horizon."

CAROLINE LIINANKI: HOW IS THIS AFFECTING THE LEVEL OF ACTIVITY IN THE MARKET TODAY?

PAUL KENNEDY: "If you look at the aggregated European data, we're down 60 per cent. Investors are sitting on their hands."

RUSSELL A. BEECHER: "The numbers for the US are very similar. I think the activity will stay very muted and it will only be when we have some stability in 10-year treasury yields that we will see more activity again."

NIKLAS TELL: WOULD YOU SAY THAT THE UNCERTAINTY TODAY IS MOSTLY TO DO WITH WHERE BOND YIELDS WILL END UP OR IS IT ABOUT THE CURRENT PRICING OF REAL ESTATE?

MICHAEL NEAL: "It's a bit of both. Your exit yield is important but at the same time the yield curve suggests that interest rates will moderate and if you can ride out the expensive period now, you should see yield compression going forward. But it's, of course, also about rental growth, which might be hit if we enter a recession. However, the occupier market has been resilient."

PAUL KENNEDY: "I don't think any economist would have forecasted the level of economic resilience that we have today considering where interest rates are. The economic models have not worked very well over the last couple of years. Things that should have happened haven't really happened. We've always assumed that as vacancies go up, rents should fall. What we're seeing today, however, is grade A rental growth at the same time as vacancies are high and rising. That relationship between supply and demand is broken and this is contributing to the reduced volumes but it's also what's creating opportunities."

NIKLAS TELL: ARE WE SEEING REAL RESILIENCE TODAY OR DOES IT JUST LOOK OK TODAY BECAUSE WE HAVEN'T SEEN THE WORST YET?

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> *– Michael Neal, Nuveen*

PAUL KENNEDY: "Let's take the office market as an example. I think you need to be very careful when you talk about resilience in the office market because it's very narrow. You're only seeing rent growth in the best quality buildings. So there's resilience but it's not across the market. Where you are seeing true resilience, however, is the logistics market and that's because of structural changes. The growth of e-commerce is pushing retail demand from the physical space into the online space and we don't have enough supply to provide the additional space. So headwind for retail and a corresponding tailwind for logistics."

RUSSELL A. BEECHER: "From a macro standpoint, I think the resilience that has been impressive is employment, even if we expect unemployment to rise. I agree with the comment by Paul on offices. In the US, we've never seen a wider dispersion when it comes to office space between what's in demand and what's not. We have, of course, seen high vacancies before but have we seen vacancies at this level with unemployment at 3.5 per cent? No, we have not. We're also seeing an increase of sub-leases. Companies need less space and if you own office space today, you really need to be honest with the degree of obsolescence how that asset is positioned to compete going forward."

PAUL KENNEDY: "After the financial crisis, one of the deals we did was the HSBC Tower. At the time, it was a liquidity play. We could go in and buy beta at a big risk premium and make a lot of money. You can't do that today. Why is that? You have the same liquidity characteristics as the GFC but the uncertainties are different. It's more complex today, particularly with regard to the occupier market. The obsolescence risk from hybrid working is one and obsolescence risk from ESG and sustainability is another. It's a more nuanced market and more stock specific today."

CAROLINE LIINANKI: WHAT DOES THIS MEAN FOR ALL THESE OFFICE BUILDINGS IF THERE IS NEED FOR LESS OFFICE SPACE?

LAURA ROBIN: "I think we're seeing a trend of people coming back to the office, especially in a city like London. We've heard that managing directors at JP Morgan need to be back in the office five days per week and at UNOPS, we're currently required to be in the office two days per week."

PAUL KENNEDY: "I think it's too early to tell for sure. If you look at regional statistics, we see that the US is back at 50 per cent, in Europe we're back at 75 per cent and in Asia they're at 90 per cent. Our view is that demand will fall too much initially as occupiers over-estimate the long-term impact of hybrid working on their requirements. Over time, requirements will increase."

ROUNDTABLE – REAL ESTATE

PAUL KENNEDY
Portfolio manager for the strategic property fund Europe at JPMorgan Asset Management. He is also head of investment strategy and a voting member of the European real estate investment committee. Prior to joining JPMorgan Asset Management in 2020, he was head of private markets strategy for the Abu Dhabi Investment Authority. He has also worked at Invesco Real Estate, Parkes & Company, Henderson Investors and Real Estate Strategy.

MICHAEL NEAL
CIO and head of funds management EMEA at Nuveen. He sits on the global executive leadership team, is a director of various Nuveen Real Estate regulated and non-regulated boards and chairs the European investment committees for both equity and debt investments. Prior to joining Nuveen Real Estate in 2008, he worked at Aberdeen Property Investors and Hammerson.

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>
> *– Paul Kennedy, JPMorgan Asset Management*

RUSSELL A. BEECHER: "We think we will see employers using their leverage to get employees back to the office and that's a long-term positive. But we will also have industries that will not be using office space in the same way going forward and there will be roles within companies that will not be required to be in the office. In general, we will need less office space but I do think there will be a lot of money made in offices as we come out of this. What's unique today is the ability to buy high-quality stock. I'm not suggesting that now is the time to catch the falling knife but the ability to buy high-quality buildings is starting to appear."

MICHAEL NEAL: "I agree. Quality will be key. We have a labour shortage and there's a war for talent and the quality of your office is one key in winning that war. We, of course, learned a lot from working from home and I'm on video meetings a lot with colleagues around the world and that's great from an improved connectivity perspective. But there is no substitute for working together with your colleagues in an office to build culture. We should also not forget how important it is for new joiners to spend time with and learn from those that have been in roles and at the business for longer periods."

LAURA ROBIN: "I read the other day that even Zoom is bringing its employees back to the office. Also, when we talk about bringing people back to the office, it's important that everyone is there at the same time to get the benefits and then you need the space for that."

PAUL KENNEDY: "If we look at our own offices – we've never used our offices five days per week. We've always travelled and had meetings outside the office. The level of occupancy has never been 100 per cent. The point of the office is to be able to bring all, or at least most, of your employees together for them to collaborate. You need to provide the space regardless of an employee uses it 20, 50 or 100 per cent of the time. The question is not if we will need office space going forward – it's rather how much and at what quality."

NIKLAS TELL: HOW HIGH ON THE AGENDA IS THE SUSTAINABILITY OF BUILDINGS?

MICHAEL NEAL: "The focus is still very much there. We see it in London where, for example, some 50 per cent of the demand is for certified green buildings and those buildings are only 15 per cent of the stock. There are clear trends emerging linking stronger demand and rental growth to sustainable buildings."

RUSSELL A. BEECHER: "From a US perspective, we're clearly behind but the focus on ESG is increasing rapidly from both investors and tenants and we believe this trend continues to gain momentum."

PAUL KENNEDY: "When it comes to ESG and sustainability, it's tempting to think about it in normative terms – you do it because you should do it. However, it's all about ensuring the quality of your future cash flows and ensuring that you don't sit with obsolete buildings in your portfolio."

LAURA ROBIN: "We've had discussions internally about putting the importance of sustainability and ESG over financial returns. It, of course, depends on each agency and their objectives for the investments but for me, it's a huge focus."

PAUL KENNEDY: "I've had one investor where the due diligence started with ESG and then moved on to the financials. It's, of course, fitting that we have this discussion here in the Nordics, which as a region is far ahead of the rest of Europe. Europe, in turn, is ahead of the US on these issues."

RUSSELL A. BEECHER: "There's so much more ESG-related data available today and we can demonstrate that being a good steward of the environment can coexist with being a good steward of capital and that an environmentally enhanced asset results in an economic enhanced asset."

NIKLAS TELL: IF YOU CONSIDER DIFFERENT REGIONS, WHERE ARE YOU CURRENTLY SEEING THE MOST OPPORTUNITIES?

MICHAEL NEAL: "We're seeing opportunities right across Europe. The UK has arguably been the fastest to mark-to-market on valuations but future refinancing events across the market are going to provide some interesting opportunities for buyers. The 'bid ask' spread remains quite wide but events like this will narrow that spread and provide a higher level of transparency."

PAUL KENNEDY: "If we look globally, I would say that the opportunities are more thematic and similar across regions rather than one region being more interesting than another."

RUSSELL A. BEECHER: "I agree with the thematic argument. We're seeing secular drivers and I would highlight demographics, e-commerce and technology. When it comes to residential rental property, demographics are creating a strong tailwind combined with high housing prices and mortgage rates that have doubled. When it comes to e-commerce, we believe we will see continued growth, which will mean demand for logistics buildings. For technology more broadly, we see continued demand for data centres and the development in AI is just the latest piece to drive that demand. Also, higher interest rates and increasing return metrics are resulting in a material slowdown in new construction starts across all sectors."

NIKLAS TELL: I WOULD LIKE TO TOUCH ON THE QUESTION OF PHYSICAL CLIMATE RISKS AND HOW YOU'RE HANDLING THAT.

PAUL KENNEDY: "It's integral when it comes to acquisitions and the management of buildings. We're significantly increasing our efforts to identify resilient assets and on the asset management side, we have an ongoing program where we look at what we can do with each building. In the core space, you try to manage your capex – making sure you improve the building to ensure that we can extend stranding dates and reduce stock turnover while maintaining asset quality."

MICHAEL NEAL: "It's about that long-term resilience and making sure that you're not buying into assets that will become significantly obsolete due to climate risks. Some locations are clearly more vulnerable than others to climate risk and additional due diligence is required."

> "I'm not suggesting that now is the time to catch the falling knife but the ability to buy high-quality buildings is starting to appear"
>
> *– Russell A. Beecher, Principal Real Estate*

RUSSELL A. BEECHER: "I think we all have a similar approach to this and it's a topic in every investor meeting. Our approach is not only assessing climate risk during our holding period but several periods beyond. This is an important topic from several perspectives including the cost of insurance where with the climate related catastrophic losses are resulting in a material spike in the cost of insurance."

NIKLAS TELL: WE HAVE TALKED ABOUT DIFFERENT REAL ESTATE STRATEGIES – IS THE DEFINITION OF CORE REAL ESTATE THE SAME TODAY AS IT WAS 10 YEARS AGO?

PAUL KENNEDY: "If you look at stock data over the last 20 years, we've seen tremendous changes in the structure of the real estate market. Retail and office are now a smaller portion of the allocation and logistics and residential have grown. Alternative and niche sectors have not grown as much as I thought it would have. The core beta that we're now looking at has changed. In addition, the way you manage that portfolio is also very different. You're still looking for high-quality cash flows but they will come from a different type of portfolio managed in a more active way."

MICHAEL NEAL: "It's also much more operational today."

PAUL KENNEDY: "Couldn't agree more. Traditional core real estate investment was relatively passive."

RUSSELL A. BEECHER: "We're certainly seeing that we have a different pie chart when it comes to allocations today. We see that in the REIT market and I think that trend will continue into the private market as well. Alternative sectors will become more important and some of these are not as institutionally priced and, we've been able to take advantage of that."

NIKLAS TELL: LOOKING AHEAD, WHAT SHOULD INVESTORS EXPECT IN TERMS OF RETURNS FROM REAL ESTATE?

MICHAEL NEAL: "It all depends on your appetite for risk. Core investors should always expect a premium above the risk-free rate but it's all about defining that risk and return trade off. It's different today as we discussed earlier as there's much more operational management even with a core portfolio today so you can't compare it to what it used to be."

PAUL KENNEDY: "Over the long-term, I think investors should expect returns of 5 to 7 per cent for core strategies with low leverage. However, current dislocations suggest materially higher returns from core quality assets."

NIKLAS TELL: WHERE HAVE YOU BEEN MOST DISAPPOINTED OR SURPRISED IN THE RECENT PAST?

PAUL KENNEDY: "I think disappointment is the wrong word but if you take logistics as an example, you were obviously hit last year when interest rates rose. With logistics being a very liquid market, it also got revalued the quickest. At the same time, it's probably the best exposure you can have going forward. What I think can be disappointing is that we see a herd mentality in the industry that causes pain. Retail is one example where the market is just dumping everything even if there are good assets in there. This, of course, creates opportunities as well."

MICHAEL NEAL: "Yes, we've always been an industry that has been guilty sometimes of throwing out the baby with the bathwater. The thing that I have found surprising in European real estate is that we haven't seen more happening in the alternative space similar to what we've seen in the US. But this is changing and the rise in alternatives in Europe is coming. We see significant opportunities in the alternative sectors like self storage and student housing."