Inflation, valuations and ESG reporting challenges

In June, **Tell Media Group**, in cooperation with **Nuveen** and **Principal Global Investors**, organised a roundtable discussion on real estate investing in Helsinki. Tell Media Group founder Niklas Tell and FBNW editor Janina Sibelius moderated the discussion.

By: Niklas Tell Photo: Christer Salling

The discussion started out with Niklas Tell asking the participants to share their broad views on real estate and where they see opportunities going forward with the pandemic being behind us and central banks starting to fight inflation more aggressively.

DAVID PEARCE: "We're still seeing a big divergence across sectors and we've seen both winners and losers over the last couple of years. Retail is still having some challenges to get through as we have this cost of living crisis and rising inflation. On the flip side, logistics is going from not being the most favoured sector to the darling of the real estate market. In general, I think the area of interest will be the alternatives market, which has structural drivers behind it and there's still capital chasing that as investors want to get more exposure. What has concerned me more recently is what we're seeing in terms of cost of debt and financing and how that will affect real estate yields. As we move into the second half of this year, I think there will be some price adjustments coming through, especially when it comes to office sector."

GILES SMITH: "As we've come out of the Covid situation, we've seen an increased focus on those alternative sectors, such as data centres. During the pandemic, we were all stuck around Teams meetings and people started realising this could be a real estate investment as well with the infrastructure that needed to be in place. It's a developing market and there will be significant demand. There are other sectors as well, such as life science and health care. These alternative sectors are underpinned by the great thematics, such as demographics for healthcare and the growth of technology when it comes to data centres. However, to the point David made – these are relatively small markets compared to logistics or offices, so the challenge is to be able to source deals. You also need the expertise in-house."

MARKUS NORDBERG: "I think what you just said Giles about in-house expertise is not only important in the alternative sector but will be highlighted across all assets. Investment selection needs to be even more rigorous today and deep expertise is more critical now than in the cap rate compression environment before Covid. You need to have the right assets and it goes across sectors. If you invest in the office space, you need to have the right post-pandemic prime office space and it needs to be super ESG in order to attract rising rents. If you're in logistics, you want to have the right modern logistics buildings."

KARRI MÄKITALO: "I agree with Markus that you need to have the right building with the right tenants. We must, of course, also keep an eye on the rising cost of living and rising inflation. One question mark that I have is what will happen to the loan-to-value ratios. We need to be careful when selecting projects that we participate in. It's one of the biggest worries for me because you have investors such as insurance companies investing under Solvency II and for them these are important measures."

TONI PERÄTALO: "Yes, you absolutely need expertise when it comes to these niche segments such as data centres and modern logistics buildings. Location is, of course, one aspect but one must also think about new technology when it comes to logistics, for example where you can have robotics and automation. We need to understand the systems in place and whether that system is tied only to the current user or whether the technology and the building are also flexible for other tenants' purposes in the future."

GILES SMITH: "I think there's an increased risk of obsolescence when it comes to logistics. Some of the assets today might be built to Amazon specification and Amazon has a lot of power in the market. But in the next 10 years, technology may change completely and what happens to your asset if someone puts up a new logistics centre next door to yours? I think it's really going back to real estate basics – it's about getting the right quality of assets in the right place that work for the occupier. If the asset doesn't meet modern requirements, then I think you will see pricing adjustments coming through."

JANINA SIBELIUS: IN WHICH AREAS HAVE PERFORMANCE BEEN DISAPPOINTING AND WHAT GROWTH PROSPECTS DO YOU SEE GOING FORWARD?

GILES SMITH: "I guess you would have to say retail as the obvious one. When it comes to office space, there were a lot of doom-mongers when Covid first came saying we would all be working remotely for the rest of our lives. That's certainly not the case and we're actually seeing very strong occupier demand in a lot of the European cities. However, for more secondary offices, I think performance has been more challenging and there's a strong link to ESG when it comes to the office sector. You need to make sure that your building is efficient and meets the highest ESG standards."

DAVID PEARCE: "I think it's very much asset specific and it goes back to property fundamentals. That could be an office building in a secondary location that hasn't got the right specification. It can even be in logistics, which is the current darling that everyone is chasing. But people might not be as diligent and compromise on fundamentals to get

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exposure. There's rental growth in that market but you must still make sure that you have the right asset to capture that growth."

KARRI MÄKITALO: "How we consume space has changed in a fundamental way. I mean, how many of us would go with the family to do the groceries today when you can order food from home? This, of course, changes the real estate sector. For the logistics sector, that means meeting the needs of e-commerce with robotics and automated picking systems and matching the sustainability targets. The tenants and the real estate owners want to own buildings that will still be used in 10 or 30 years and that are aligned with our climate targets. If we have that, then we have the right product and the pricing power."

TONI PERÄTALO: "Also, it's not only related to the building itself but the infrastructure around that building and that's also changing with new ways of transportation etc. There are plenty of unknowns but the things we do know are changing."

GILES SMITH: "Yes, it's difficult. Technology is changing how we use buildings and the pandemic changed the way we use offices and logistics buildings. As real estate investors, we need to be at the forefront of trying to understand where the occupational demand is going."

NIKLAS TELL: IS THIS ALSO CHANGING YOUR GENERAL VIEW OF WHAT'S CORE AND WHAT'S ALTERNATIVE REAL ESTATE?

GILES SMITH: "I think the fundamentals of how you classify a core asset is the same. It's about the quality of the location and the quality of the tenants and the income. However, there are assets now that you would consider for a core fund that we wouldn't have 10 years ago. Health care is one big asset class that's becoming more mainstream and we see the same with student accommodation. As we continue into this inflationary period, people will be looking for exposure to social infrastructure and more defensive assets. Typically, an average health care asset has very long-term leases with inflation uplift on an annual basis."

TONI PERÄTALO: "I think what has changed after the pandemic is that residential has become increasingly interesting as well as logistics and also public sector assets, including healthcare. When you look at the attributes of those assets, there's usually a strong tenant base where you either have public support or, for example in residential, the tenant base is such a big group so it doesn't matter if someone leaves as someone else will be coming in."

NIKLAS TELL: MOVING ON TO THE TOPIC OF ESG. WHERE DOES ESG INTEGRATION COME INTO THE PROCESS FOR YOU, MARKUS?

MARKUS NORDBERG: "The problem in our asset class is the access to data. That said, it's more and more clear that properties can offer a green premium, so investors probably should invest into green buildings. But then again, those premiums have costs, so you have to balance the premium with the cost. At the same time, more and more companies have net-zero carbon targets, so in order to ensure someone will lease your space, it needs to have a high ESG rating. This also comes back to the discussion about the new core and ESG absolutely has a place in that equation. In order to attract the highest price from institutional buyers that are looking for a core and safe exposure, you have to have a high ESG rating. So to us, the ESG is in the process from the very beginning and ever present."

KARRI MÄKITALO: "I fully agree with Markus – it's impossible to be in real estate today and not have full control of the ESG factors. I think one of the topics that have been a little bit on the sideline is the impact of material and the construction of a building. A large proportion of the lifetime CO2 of a building comes from the factory or plant where the building materials are created. We therefore need to look more holistically at these issues and also look more at recycling."

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> *– Markus Nordberg, Mandatum*

GILES SMITH: "I agree that this is becoming a bigger issue. Investors, particularly in Europe, are asking questions about embodied carbon and whether we're measuring it and looking at the life cycle of the building. I think one of the biggest challenges is getting a consistent way for the industry to measure, report and monitor greenhouse gas and carbon reduction. We, and a lot of other managers, spend a lot of time looking at how to come up with a transparent way of providing data to investors. The challenge we have is that those investors have very bespoke ways they want the data delivered, so reporting becomes a huge task."

DAVID PEARCE: "It's only more recently that we see evidence of green premiums, so premium rents on office buildings, for example. The balancing act real estate investors have to make is looking at the capex – the money you spend to get there – but there's definitely value enhancement to pursue these issues. Again, it varies between sectors and offices are probably more at the forefront with the occupier really driving that development. It's more challenging in other sectors, such as residential, and that partly comes down to data."

GILES SMITH: "Before the pandemic, we were trying to get some tenants to sign a green lease addendum so that we could measure how much energy they were using. At the time, it was difficult and they wanted to know why they should do that. Today, it's pushing at an open door. Corporate tenants have net-zero targets and they want to know how much energy they're using and they want to be able to show that they're improving. That's encouraging."

NIKLAS TELL: WHEN WE TALK ABOUT ESG, IS IT REALLY THE "E" THAT IS THE FOCUS WHEN IT COMES TO REAL ESTATE?

MARKUS NORDBERG: "Well, real estate has a large carbon footprint and the EU reported in 2019 that over 80 per cent of the current stock of real estate will still be standing in 2050 when we need to meet those net-zero targets. So it's quite a task before each property is somehow changed to be running net zero operationally. It's just a huge energy transition required and if you look at the climate targets, it will probably require more regulation."

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GILES SMITH
Head of fund management at Principal Global Investors, responsible for fund management services provided by Principal Real Estate Europe. He joined Internos Global Investors in 2008, which was acquired by Principal Global Investors in 2018.

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>
> *– Giles Smith, Principal Global Investors*

TONI PERÄTALO: "The attitudes of investors have changed rapidly when it comes to ESG but what hasn't changed as quickly is the construction industry. Another problem is that the buildings that are built today were planned a few years ago and what's now being delivered is not green enough as things are moving quickly in this area. It becomes a mismatch between what investors are looking for and what's currently available."

NIKLAS TELL: WHAT ABOUT CLIMATE RISK IN TERMS OF THE PHYSICAL RISK OF OWNING BUILDINGS IN AREAS THAT MIGHT BE FLOODED ETC?

GILES SMITH: "It's something that we've incorporated into our due diligence on assets. You look at the potential impact of climate events on the value of assets and how exposed they are and then you can make an informed decision. Both on the steps you can put in place to mitigate this or whether you proceed with the asset at all. It's increasingly important for lenders, for investors and for insurers to have that transparency and clarity on the risks."

NIKLAS TELL: WHAT ABOUT GREENWASHING WHEN IT COMES TO REAL ESTATE? IS THAT AN ISSUE YOU NEED TO CONSIDER AS INVESTORS?

KARRI MÄKITALO: "My take would be that real estate doesn't need to greenwash anything because it offers a real opportunity to contribute to the environment by taking buildings to net zero. In the end, that should be good for your returns."

DAVID PEARCE: "I think it comes down to having a uniform level of looking at this. Today, each country and each company all have slightly different ways of measuring and reporting. If you call that greenwashing then yes, there's an issue with greenwashing."

NIKLAS TELL: IS REGULATION BEING DISCUSSED FOR THAT?

GILES SMITH: "We have the joy of SFDR at the moment and there's a lot of fixation right now on whether you're an Article 8 or 9 fund and what that means. I've sat through so many meetings with lawyers and our team on these issues. For the industry, I think there's a risk that Article 9 funds will become a label for a 'green fund' rather than what it was intended to do, which is to provide information on the strategy of the fund. Also, interestingly – if you want to make a bigger impact on carbon reduction, an Article 8 fund may be better than an Article 9 fund, so there's that misconception that a higher number is better. So again, it's all about transparency and making sure people understand what a fund is trying to achieve and how it's trying to achieve it."

DAVID PEARCE: "Our new value-add fund is Article 8 and from a capital raising point of view, SFDR is definitely on everyone's agenda. When we looked at launching the fund, being Article 8 was critical."

TONI PERÄTALO: "If I just quickly come back to potential greenwashing. As we're moving towards net zero, there are certain things you can do. One is to cut down your CO2 emissions and another is to use green energy. There's, however, likely to be a small part left that you have to compensate. Here, I think there could be a risk that some investors will take the cheaper route on how to compensate, for example using compensation that cannot be adequately guaranteed. That's something to look out for and make sure your compensation is rock solid."

GILES SMITH: "One way to create a greener asset is to simply procure renewable energy and use offsets. The challenge in the real estate industry is that there's only a finite supply of green energy in the grid at the moment. So if you just procure green energy for an inefficient assets, you will not really solve anything but instead you're denying other people the ability to access that. I think the focus has to be on efficiency of the assets rather than just procuring green energy."

NIKLAS TELL: TALKING ABOUT MAKING BUILDINGS MORE EFFICIENT. HOW BIG OF A PROBLEM IS INFLATION AS THE COSTS KEEPS RISING?

DAVID PEARCE: "It's, of course, a challenge if you did appraisals a couple of years ago and with the inflation we've seen and still see, that's a challenge for real estate investors. If you bought an asset a couple of years ago based on certain assumptions, the capex to incorporate some basic ESG initiatives within that building will now be higher."

TONI PERÄTALO: "If you look at the residential segment, inflation is a problem because occupancy rates in Finland have been falling at the same time and if you increase rents, the tenants might simply move to another just completed new building next to the current one. It's different in some commercial segments, such as grocery stores that can push forward their increased costs to their customers. With such tenants, it's more likely possible to increase rents according to the indexation."

NIKLAS TELL: HOW GOOD IS REAL ESTATE AS AN INFLATION HEDGE? IS IT GENERALLY GOOD OR IS IT VERY SPECIFIC TO THE SECTOR OR EVEN THE BUILDING?

GILES SMITH: "If you look at the data, and there's a lot of data available on the US and the UK, the real estate sector has outperformed inflation from a total return perspective. I think the issue here is understanding the types of inflation and the drivers behind that. We've got cost push inflation at the moment and in a lot of European countries we haven't seen wages rise in line with that. The big risk is the threat of stagflation and what that means for real estate. If you have very low levels of economic growth, which we're seeing some countries, and high inflation some sectors, such as logistics, you will not able to push increased costs through to the customers. There will be a pinch point where you're unable to go through with those CPI increases."

MARKUS NORDBERG: "This again highlights the importance of rigorous investment selection to ensure that you're invested in the right assets where you have the pricing power."

DAVID PEARCE: "Over the last 40 years, property in the UK has outperformed inflation but there are of course differences between sectors. Up until 2010, retail was outperforming significantly but more recently it has underperformed, which highlights what we said in the beginning about having sector specific expertise."

ROUNDTABLE – REAL ESTATE

> "Financing costs are on everyone's mind right now and the question is what impact that will have on the pricing of prime office logistics buildings"
>
> *– David Pearce, Nuveen*

NIKLAS TELL: LOOKING AHEAD, WHAT ARE SOME OF THE TRENDS YOU'RE SEEING AND WHAT ARE YOUR MAIN WORRIES GOING FORWARD?

KARRI MÄKITALO: "Inflation and building costs, tenant quality and valuation of assets are some of the main themes we're focusing on. That's, of course, in addition to ESG-related issues."

DAVID PEARCE: "We've touched on inflation and rising interest rates and the effect that will have on markets. And I'm coming back to being sector specific as I think some sectors will do better than others and it's up to us to make sure that we're invested in the right geographies and the right sectors. Financing costs are on everyone's mind right now and the question is what impact that will have on the pricing of prime office logistics buildings."

GILES SMITH: "I guess there's uncertainty and risk around Russia and its actions in Ukraine. What impact would it have on investor confidence if that would spill across the border into Poland? When the invasion initially happened, we did see Asian investors press the pause button for a period of time when it came to activity in Poland. That's now returning but that's clearly a worry."

DAVID PEARCE: "If I were to share some last thoughts, it's what we talked about in the beginning about getting back to the basics of real estate – supply and demand. You need to ask if there's going to be sustained tenant demand for the location that you're looking at and you need to ask why the potential tenant should be there. A favourite of mine is urban logistics. There's typically scarcity of land within cities, which means there's obviously higher value alternative uses further constraining the supply of logistics space."

TONI PERÄTALO: "I think one interesting development is smart homes. We're not there yet but we're moving in that direction to the benefit of both tenants and owners. The development is, however, still fairly slow."

GILES SMITH: "There's a lot that can be done with prop tech. You can have comprehensive systems to monitor energy use in different points and then have software that analyses why you got a peak of electricity use at two o'clock in the morning for example. I therefore think there's a lot that can be done to existing assets to identify how to improve the efficiency. We're looking at smart meters across our portfolio as well and that will hopefully deliver results."

MARKUS NORDBERG: "I agree completely. Prop tech has been on our mind for a long time but its implementation has probably been slower than expected in some areas, like the residential sector. But it clearly continues to be important in many ways."