



IPM

Our semi-annual insights
into private markets

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Dear readers

As we approach the end of 2023, markets are grappling with competing dynamics. US President Harry S Truman once quipped, “Bring me a one-handed Economist. All my Economists say, ‘on the one hand... on the other’.” Seventy years later, investors have more data, faster information flow and yet face similar complexities when trying to foretell the future. On the one hand, inflation is slowing, and economic growth persists. On the other hand, the weight of higher interest rates takes time to impact global economies while political unrest looms.

One year ago, rising interest rates were just beginning to combat near-record inflation. War in Ukraine added risk to forecasts, and many economic predictions called for a contraction before the end of 2023. Fast forward to today, unrest in the Middle East now captures headlines, and instead of painful recessions, global economic growth held up during the middle of the year.

For most economies, interest rate hikes are at, or nearing, an end. Despite the economic outperformance, risk premiums still fall short of enticing more buyers to bid. Sellers may be able to afford to hold. In US core real estate, net operating income grew 4.2% in the year ended September 2023, 50 basis points higher than headline inflation.

Will contractions begin? Will transaction markets accelerate? Read on for our latest intel on global economies and implications for private markets investments.

“Risk premiums still fall short of enticing more buyers to bid. Sellers may be able to afford to hold.”

Tiffany B. Gherlone
Head of Real Estate
Research & Strategy
– US



Global real estate

Ongoing price adjustment



Debt looking attractive

“Real estate capital values continue to edge lower, with the US lagging Europe, and APAC little impacted as Japanese interest rates remain on hold. Transaction activity remains muted while lending conditions have tightened. This is creating attractive opportunities for real estate-backed debt, such as bridging loans.”

Fergus Hicks,
Real Estate Strategist



Ongoing challenges for real estate markets

Initial estimates from statistical agencies painted a mixed picture of economic activity in 3Q23. US growth accelerated to a blistering 4.9% Quarter on Quarter (QoQ) annualized while, after a lull in 2Q23, the Chinese economy picked up to show growth of 1.4% QoQ. However, China remains mired by a housing market downturn, house developer defaults and weak consumer confidence. The eurozone economy was lackluster and shrank 0.1% QoQ, having grown 0.2% QoQ in 2Q23. Ireland, which propped up the eurozone in 2Q23, was a significant drag in 3Q23 as its volatile economy shrank by 1.8% QoQ.

A key question is the US's ability to remain resilient and defy recession. The US jobs market finally showed some signs of softening in October as employment growth slowed to 150,000 jobs Month-on-Month (MoM). Given the very strong economy in 3Q23, a decline in GDP in 4Q23 looks increasingly unlikely. However, we do expect a slowdown of some sort in the first half of 2024 as the very rapid rise in interest rates over the past 18 months continues to feed through. Moreover, a slowdown is likely needed to keep a lid on inflation and stop it from rising again. The narrative on interest rates has shifted to higher-for-longer, particularly for the US, and the 10-year Treasury bond yield touched 5% briefly in October.

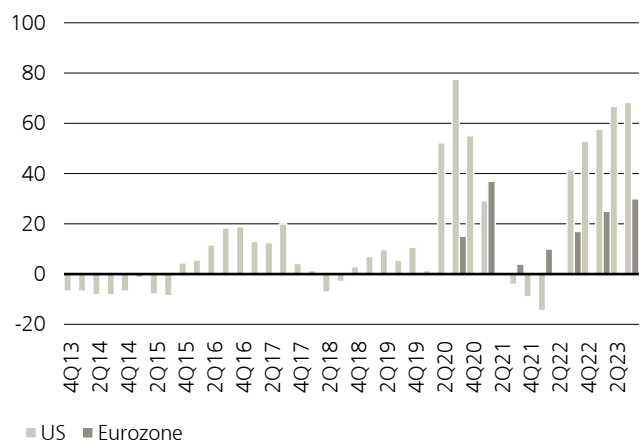
War in the Middle East creates a new risk and uncertainty for the global economy and real estate markets. Following the attacks against Israel on 7 October, the benchmark West Texas Intermediate (WTI) oil price rose 8% above its pre-conflict level. However, by the end of October it had fallen back and was actually slightly below its pre-conflict level. Any widening of the war beyond Israel and the occupied Palestinian territories could lead to an interruption in oil supply and exert upward pressure on oil prices. This could presage a supply-side shock to the global economy and simultaneously generate renewed inflation pressures and bear down on growth.

According to MSCI data, investment activity in real estate markets remained subdued in 3Q23 as sharp interest rate rises continued to feed through and a wedge remained between the price expectations of buyers and sellers. After allowing for seasonal effects, global real estate investment volumes fell 13% QoQ in 3Q23 in USD terms, leaving them down 59% from 2Q22. All geographies and sectors have been affected by the downturn. Asia Pacific residential has been more resilient, with volumes down just 11% since 2Q22, supported by the large Japanese market, which has not suffered from interest rate rises.

Real estate capital values remained under downward pressure in 3Q23. Data from the National Council of Real Estate Investment Fiduciaries (NCREIF) showed that US capital values dropped a further 2.4% QoQ, leaving them 12.4% below their peak in 2Q22. MSCI reported that UK capital values fell 1.7% QoQ, to leave them 20.2% below their 2Q22 peak. At the global level, latest forecasts from Oxford Economics are for a drop in capital values of around 9% in 2023. Japan has continued to be a resilient market, with latest data from MSCI showing capital values flat in 1H23, marking a significant relative outperformance.

Banking sector stress has eased since the first half of the year, though further rises in interest rates and downward pressure on bond values may create additional constraints on lending. Surveys of bank lending standards against commercial real estate have shown a continued tightening since mid-2022 in both the US and eurozone. Indeed, in 3Q23, a net 68% of large and mid-sized US banks reported a tightening in credit standards, as did a net 30% of eurozone banks (see Figure 1). Tighter credit markets make it more difficult to refinance existing debt secured against real estate and also to take on debt for new real estate investments.

Figure 1: Bank lending standards on commercial real estate (net balance of survey respondents reporting a tightening, %)



Source: ECB; Refinitiv Datastream; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Note: ECB survey is bi-annual from 3Q20. **Past performance is not a guarantee for future results.**

Although tighter credit markets are invariably leading to pain for some real estate investors as they struggle to refinance debt, they are also creating opportunities for others. Debt backed against real estate assets for bridging loans or loans to finance real estate development can achieve double-digit returns in some cases. Moreover, such opportunities should remain as lending markets remain tight.

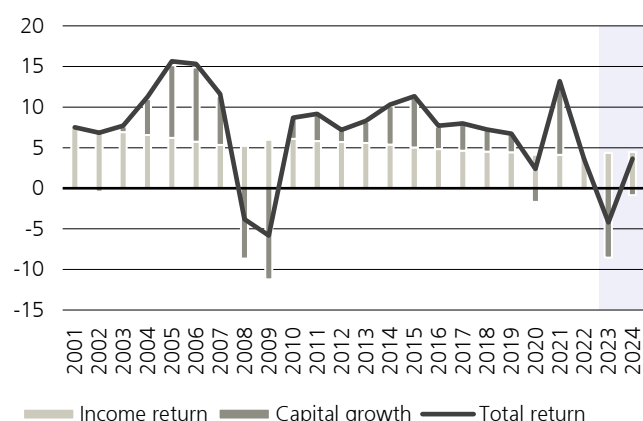
Income-driven returns expected in 2024

2023 has been a tough year for real estate markets around the world as they have digested sharp and rapid rises in interest rates. The result has been a marked contraction in investment activity and significant declines in capital values. Japan has been an exception regarding capital values, which have held steady as Japanese interest rates have remained on hold. The difference in performance between Japan and other markets serves as a reminder of just how important interest rates are for real estate markets. Investors have also had to cope with political uncertainty, ongoing war in Ukraine and the outbreak of a new conflict in the Middle East.

We think that in 2024 real estate markets will stabilize and that the re-pricing will come to an end. We expect the UK market to bottom out first, followed by the rest of Europe, while the lagged response in US valuations means that we expect these to bottom out last. We also expect some further modest declines in capital values in Asia Pacific markets as higher interest rates feed through.

At the global level, the latest forecasts are for income-driven returns in 2024 of just below 5%, following a negative total return of -4% expected for 2023, dragged down by a 9% fall in capital values (see Figure 2). From 2025 onwards, as economies resume growth and interest rates have started to fall, we expect capital growth to resume and that real estate returns will show some acceleration.

Figure 2: Global real estate returns (unleveraged, local currency, % YoY)



Source: MSCI; NCREIF; Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. **Past performance is not a guarantee for future results.**

This outlook is consistent with global listed markets, which showed renewed weakness in 4Q23 as conflict broke out in the Middle East and as interest rate expectations moved to higher-for-longer.

The FTSE EPRA Nareit Developed Index of global listed market prices touched a new low in October, following its high at the end of 2021. This implies that market conditions for private real estate will remain challenging in the near term at least, though we think that the bulk of the adjustment in capital values will have taken place by the end of 2023.

We continue to expect offices to be the weakest performing sector due to the ongoing impact of the adjustment to hybrid working and capex needed to make older offices energy efficient. We do expect prime, well-located offices with good sustainability credentials to be more resilient and perform better. We think that the retail, industrial and residential sectors will show broadly similar performances at the market level. Overall, we favor the industrial and residential sectors though and believe that they have good fundamental occupier market drivers.

We think that the retail sector, having faced a hard period of structural adjustment prior to the pandemic as retail shifted online, and then challenging conditions during pandemic lockdowns, should perform more in line with the market overall. Within retail we favor convenience and neighborhood retail, which is supported by consumer demand, and prime grade retail in the best locations, which also benefits from tourist spend. By contrast, secondary grade retail and malls are likely to continue to underperform, with some of these properties still likely to need re-purposing.

Having strongly boosted returns during the post-Global Financial Crisis decade and over the pandemic period, debt is often no longer enhancing to returns in a higher interest rate environment. Once interest rates eventually start to fall, we expect debt to be able to contribute to performance again. In the meantime, real estate fund managers will not be able to rely on debt to boost returns. Rather, they will need to focus on strong property selection, good asset management initiatives and taking advantage of distressed and discounted opportunities to drive performance.

How real estate markets fare in 2024 will critically depend on interest rates, over which there is significant uncertainty. At best, we expect some modest declines in policy rates next year. A higher-for-longer path would likely curb property market performance, while if inflation prints allowed central banks to cut interest rates faster than expected, a stronger recovery in real estate markets could result. Hence investors should carefully monitor the interest rate outlook as it evolves and consider its implications for real estate markets. In the higher rate environment, property-backed debt investments are a good opportunity for investors, particularly if bank lending is constrained.

Unlisted real estate sector performance outlook

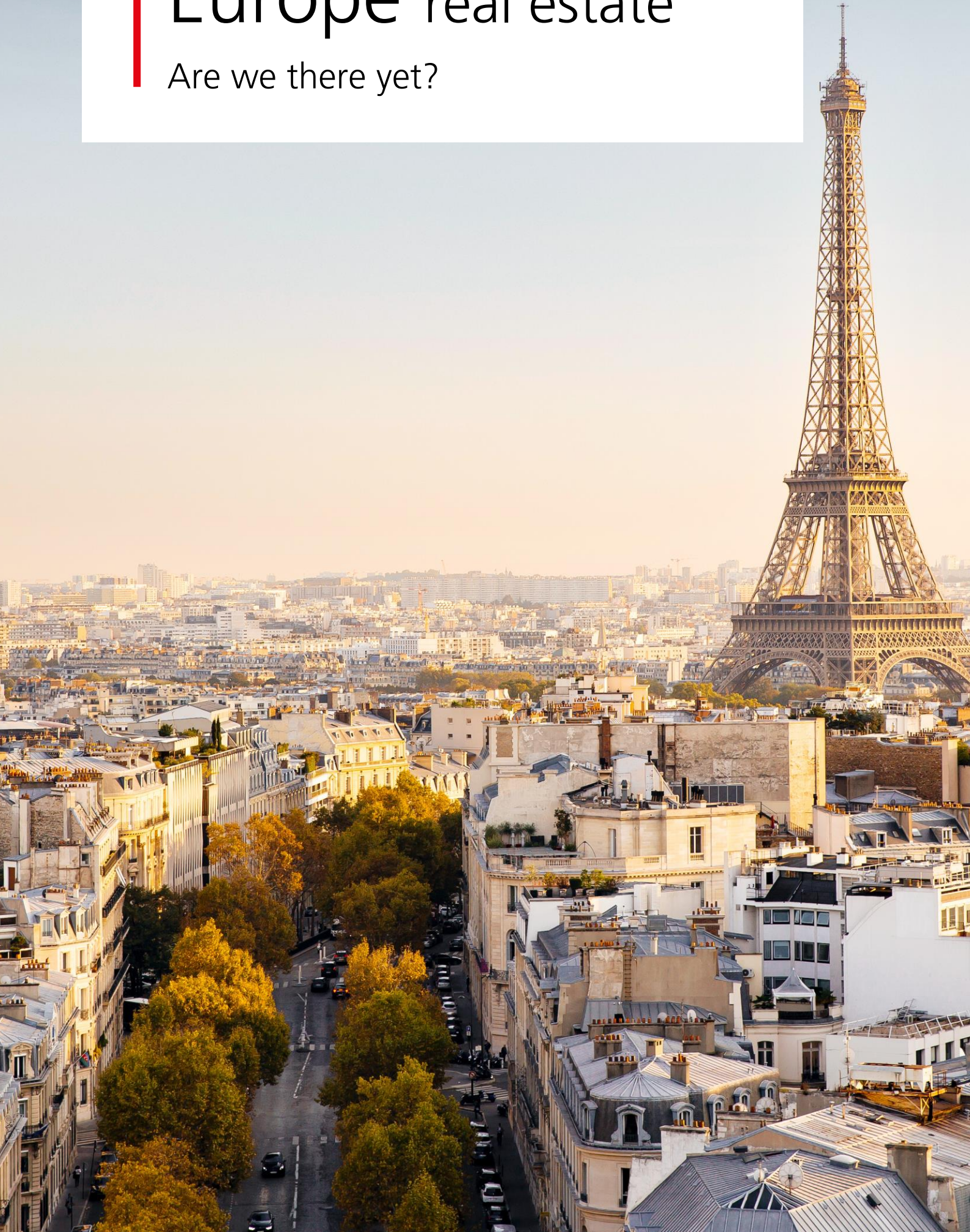
	Negative	Neutral		Positive
US	Office	Residential, hotel	Retail, industrial	
Canada		Office, retail, industrial, residential, hotel		
France		Office, residential	Retail, industrial, hotel	
Germany	Office	Retail, residential, hotel		Industrial
Switzerland		Office	Retail, residential, hotel	Industrial
UK	Hotel	Office	Residential	Retail, industrial
Australia	Office	Retail	Industrial, residential, hotel	
Japan			Office	Retail, industrial, residential, hotel
Singapore		Office, retail	Industrial, hotel	

Source: Oxford Economics; UBS Asset Management, Real Estate & Private Markets (REPM), November 2023.

Note: Classifications refer to expected total returns after currency hedging over the period 2024-26 versus global all property. **Classifications are not a guarantee for future results.**

Europe real estate

Are we there yet?



Continuing polarization

“Markets with the most robust leasing market fundamentals are likely to find the trough in values ahead of weaker ones.”

Kerstin Hansen, Research Analyst – Real Estate DACH

Olaf Margeirsson, Head of Global Research – CSAM



Softer economy with possible showers

Economy

The economy in the eurozone is weakening but still holding up better than expected. After two quarters of meagre growth of 0.1%, the 3Q23 GDP for the region contracted by -0.1%. The purchasing managers' index (PMI) survey results, with five consecutive readings below the neutral threshold of 50, resulting in a three-year low of 46.5 in October, suggest an even weaker start to 4Q23. Hence, the headwinds resulting from the European Central Bank (ECB)'s restrictive monetary policy, the weak external environment and somewhat tighter fiscal policies are showing their effects.

On the other hand, the strong labor market, with an unemployment rate still at a record low of 6.5% in 2Q23 and real wage growth becoming positive again, supports household consumption. All combined, a growth of 0.5% and 0.6% in 2024 is expected in the eurozone. While the economic outlook in Europe has improved compared to the gloomy outlooks that we were facing last winter, downside risks remain, particularly due to growing geopolitical instability. The risk of monetary policy powers having overreacted to the inflation dynamic – too much and too late – should also not be ignored.

While robust private consumption has stabilized the economy above last year's expectations, it has also meant that inflation, especially core inflation, has lasted longer than expected. While the inflation rate in the eurozone has fallen from its peak of 10.6% in October 2022 to 2.9% in October 2023, core inflation remains stubborn at 4.2%. The high inflation rates have prompted the ECB to make a total of 10 interest rate hikes since July 2022, raising the deposit rate to 4.0% and the main refinancing rate to 4.5%.

As expected in the recent October meeting, we saw no further increase as the ECB stuck to its previous guidance that interest rates are likely to have peaked, while pledging to keep rates sufficiently high as long as necessary to bring inflation down to 2%.

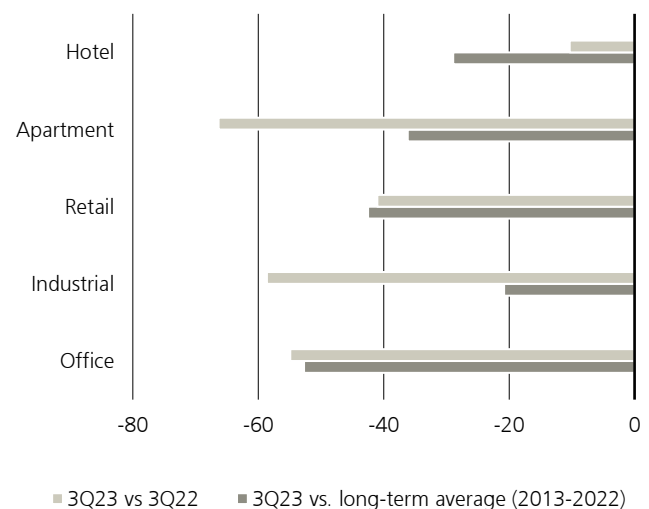
Capital markets

The drastic changes in the macroeconomic environment, especially in monetary policy, have not left the European real estate market unscathed. The overall increase in key interest rates of 450 basis points has also raised yields on government bonds, significantly shrinking the spread between the risk-free rate and the yield on real estate.

Although real estate yields have – with some delay – started to react to the changed conditions, the spread remains relatively low by historical standards. Thus, there is currently a disagreement among buyers and sellers as to what the new fair price level is and whether the value correction process has been completed. In addition, the sharp rise in financing costs makes debt financing for real estate investments unattractive, except on assets with very attractive rental growth prospects, and restricting the group of potential investors, who are today dominated by cash-rich entities.

As a result, European transaction volumes have severely contracted. According to MSCI, the total annual transaction volume in Europe in 3Q23 was almost 54% lower than the previous year's figure, falling to levels of 2009/10 in terms of nominal EUR investment volume. While the third quarter is traditionally the slowest, the EUR 32.8 billion investment volume in 3Q23 was still 57% below that of 3Q22 and 44% below the 15-year average. The sharpest year-on-year declines were recorded in the residential (-66%) and industrial (-59%) sectors, which boomed during the pandemic, while retail and hotel, that already suffered during the pandemic, recorded the smallest decline (see Figure 1).

Figure 1: Change in transaction volumes by sector (%)



Source: MSCI, 3Q23.

Occupier markets resilient

Occupier markets

Economic slowdowns, like the current one, traditionally hit the commercial real estate market, particularly the office space market. However, the slowdown so far has had minor impact on the labor market as companies have tended to refrain from laying off employees due to the shortage of skilled workers. The effect of the economic slowdown on the labor market is therefore weaker than in past downturns.

But even without layoffs, companies are trying to save on operating costs, which is reflected in a reduced demand for space. According to Savills, office leasing activity has slumped by 21% compared to the previous year. More important than the current cyclical effects, is the structural change in the office user market, initiated by remote working possibilities, which the pandemic strongly accelerated. Home office and hybrid working are now fully established, albeit to a different degree, across Europe's largest cities.

This does not mean that the office has become obsolete, but less space is needed, leading to increases in headline office vacancy rates. However, the space that is in demand has higher quality requirements. Since companies must remain attractive to employees, especially in times of a shortage of skilled workers, the demand for attractive, accessible, modern, sustainable space promoting communication between employees is increasing. The share of A-properties in total space demand has risen noticeably over the past few quarters, and prime rents are rising sharply despite structural problems, illustrating the polarization in the market.

As an example, relying on data from CBRE, prime office rents increased by ~8% in London's West End, by nearly 9% in the center of Amsterdam and by more than 12% in key areas of Munich over the year ending in 2Q23. Lower quality office assets are struggling, however, to deliver any rental growth as demand for their space has shrunk.

As the pandemic led to a strong acceleration not only of home office but also of online retail sales, the bricks-and-mortar retail sector suffered significant declines in rents in 2020 and 2021. Meanwhile, the share of online in total sales has stabilized, allowing for a slight recovery in retail rents in 2022 and 2023. Accordingly, the outlook for retail rents is now slightly brightening, albeit – as in the office sector – particularly for high-quality properties in locations with high pedestrian frequency.

The logistics sector generally remains pushed by positive structural changes, though the economic slowdown is currently reducing the demand for space. At -42% compared to the previous year, the decline in leasing activity seems drastic, but given that this corresponds to pre-pandemic levels, it can be described more as a return to normality. The high demand for logistics space caused European prime rents to rise by an average of 12% in 2022, according to the Property Market Analysis (PMA). Digitization, including ecommerce, and increasing deglobalization tendencies mean that the demand should not lose its dynamic drastically in the medium term. Hence, at 3.2% p.a. rental growth prospects for the next five years remain very positive.

The rental housing market is traditionally least affected by economic downturns. Currently, the strong increase in financing costs is pushing prospective buyers (back) into the rental market, which increases demand further. Though population and household growth are expected to grow at a more modest pace in the future than they did over the past five years, the low expansion of supply lets housing remain scarce. Hence, expected rental growth remains substantial across Europe and above the expected inflation rate in most markets.

The trough in capital values: are we there yet?

2023 has been difficult for many investors – and not only in real estate – with record low liquidity levels, rising refinancing pressures and soft investor sentiment. Many are eager to know where and when the trough in capital values is taking place.

We are currently in an unusual stage in the real estate capital value cycle. On the one hand, the pressure from rising interest rates has been immense over the last ca. 18 months. Prime yields in German and French office markets are up ~150-220bps from March 2022 and ~100bps in some (eg., Berlin and Amsterdam) year-to-date (YTD) 2023 alone. Likewise, yields in the logistics sector are up ~100-150bps since 1Q22. This yield shift has pressured values downwards by ~20-40% in many markets and has only partially been met by positive rental growth, creating the exceptionally weak sentiment in the market that we currently observe.

At the same time, a structural shift in leasing markets is taking place. As previously discussed, logistics and manufacturing assets are in strong demand, and there is a shortage of homes for rent. Retail rents have started their recovery after the pandemic shock and the challenge brought forward by the rise of e-commerce.

And while low-quality offices are struggling, with many of them ending economically (and, in many cases, environmentally) stranded as tenant demand evaporates, the prime sector of the office leasing market is doing relatively well. The preference for prime-quality assets is also well observable in other sectors, leading to prime rental growth in the retail, office and logistics sectors being quite strong compared to its most recent and long-term trend (see Figure 2).

Figure 2: Annual rental growth by sector, EU-15 countries (%)

	Office	Retail	Industrial	Combined
Last 1 year	4.8	5.1	8.6	5.2
Last 3 years	3.9	-1.8	8.1	1.5
Last 5 years	3.7	-1.9	6.1	1.2
Last 10 years	3.5	1.9	4.4	2.8
Last 20 years	2.2	3.2	2.0	2.6

Source: CBRE, October 2023

Past / expected performance is not a guarantee for future results.

Of course, the strong rental growth for prime assets has been assisted by the somewhat resilient economic dynamic and it is a valid question to wonder what will happen to rents now that the economic outlook is softening. We believe that prime rental growth should be relatively robust given where we are in the economic cycle for two key reasons.

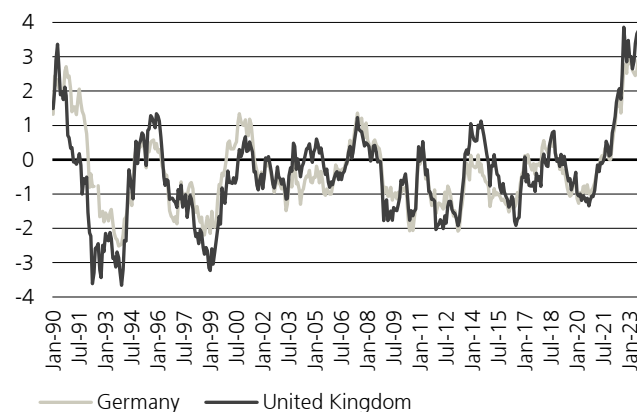
First, the rise in construction costs, caused by the pandemic supply-chain shocks, has contributed to limited supply pipeline risks in most markets, greatly reducing the risk of a sharp correction in rents. Second, occupier demand is shifting towards the prime sector in leasing markets – offices being the most notable example of that – while toughened environmental standards are affecting the supply of eligible assets in leasing markets. In short, this is not a leasing market that smells of a serious downturn in terms of prime rents even if the economy slows down.

It is also interesting to consider how sharply interest rates have risen over the last two years and consider the future in light of similar trends in the past. Figure 3 shows that the 10-year Bund and the 10-year Gilt have recently risen at their fastest pace since at least the early 1990s.

If history is any guide, such a rise in financing conditions slows the economy down, which allows central banks to ease their monetary policy stance. And the slowdown has already started, eg., with the German economy clocking at an annual growth rate of -0.4% in 3Q23, its slowest pace since 1Q21.

In the past, it was not unusual to see long-term interest rates drop by ~150bps over the next two years after their cyclical peak. If interest rates have now peaked, we may well see the 10-year Bund and the Gilt near ~1.5% and ~3.0%, respectively in two years' time, with an intermediate target of ~2.3% and ~3.5% in 12 months. This would certainly be a welcome pressure release in real estate capital markets as yield spreads would recover towards their historical means from their current lows.

Figure 3: 10-year government bond yields: 2-year change (%)



Source: Refinitiv Datastream, October 2023. **Past performance is not a guarantee for future results.**

So where from here? Our base case is that we should be getting close to the trough in terms of capital values in transaction markets. Careful differentiation is important here though, as the markets with the most robust leasing market fundamentals; eg., the logistics, housing, and prime-quality offices sectors are highly likely to find the trough in values ahead of weaker ones; eg., low-quality offices. On a risk-adjusted basis, we favor logistics and our view on retail is turning more positive given the recovery in rents.

Only a handful of office markets seem attractive on a risk-adjusted basis unless investors are willing to step out on the risk curve and accept value-added exposure. Given the lack of liquidity in the office market, and the expected shortage of energy-efficient buildings in leasing markets a few years from now, it is indeed likely that a sharp investor with good understanding of an asset's potential after a refurb focused on ESG credentials can find attractive risk-adjusted investment opportunities in the current market environment. 2024 may well turn out to be a relatively good vintage year in terms of real estate value-add investments in Europe.

APAC real estate

Navigating choppy waters



Buckle up

“Macro is likely to lose momentum further given restrictive monetary policy. More cap rate expansions are forthcoming with rates staying higher for longer. There are more risk factors to consider, and investors should stay selective in strong thematic plays.”

Wai-Fai Kok

Head of Real Estate, Research & Strategy – Asia Pacific



More pain ahead?

The economy

APAC GDP is projected to grow a robust 4.7% YoY in 3Q23, according to UBS Investment Bank. For the full year, GDP growth is forecast to accelerate from 4.2% in 2022 to 4.9% in 2023, higher than previous expectations 6-12 months ago. A low base effect driven by the late reopening of China, Hong Kong and Japan was an easy win and well anticipated. The sturdy domestic consumption and labor markets, however, were not our base case. This was remarkable especially considering the sharply higher interest rates, elevated inflation and softer external demand. Consumer sentiment surveys have been painting a bleak picture for several quarters now, but they were largely an ineffective indicator for the year. Negative real wage growth has been well buffered by a drawdown of pandemic savings.

Employment is strong, inflation is falling and economic fallout from monetary tightening is limited. This was a better macro outcome than most had hoped for. However, the disinflation trend seems to have stalled, and the rates are still too high. Upside risks have also increased lately given higher oil prices and a strong US dollar. Interest rates staying "higher-for-longer" is now the buzzword and this seems inevitable without a faster cool down.

In APAC, UBS Investment Bank expects most central banks to stay on hold until the start of a rate-cutting cycle in 2H24. Of course, this is based on economic weaknesses becoming more apparent next year. Among the advanced economies, the Australian economy is still considered to be too 'hot' and the Reserve Bank of Australia may have to hike more. Japan is inching closer to its inflation target and the Bank of Japan is waiting for confirmation from wage data. The consensus is to pencil in a negative interest rate policy (NIRP) exit in April 2024.

With monetary policies remaining restrictive, APAC GDP growth is likely to lose further momentum in 1H24. There will likely be a rebalancing of growth contributors with softening domestic demand partially mitigated by a bottoming out of external demand. The recent improvements in manufacturing PMI in Taiwan and South Korea indicate a trough in the semiconductor cycle. Overall export performance is also firming up. Indeed, the consensus is that export-reliant countries like Singapore, Taiwan and South Korea will grow faster in 2024. In the case of China, the economy will continue to muddle through. Recent data is positive but not conclusive. The property sector is still in the doldrums. The positive news is that the authorities seem ready to respond. Nonetheless, we are not expecting any big policy easing given the focus on 'quality' growth. A return to pre-pandemic glory is unlikely. UBS Investment Bank forecasts GDP growth of 4.4% in 2024, slower than 5.2% in 2023 and 6-7% in 2015-19.

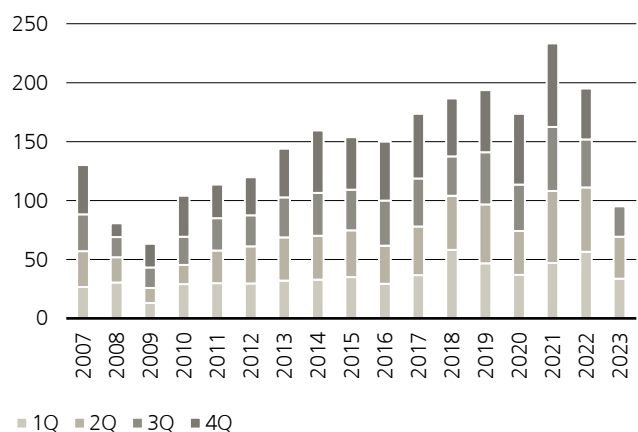
Leasing and capital markets

APAC leasing activity improved QoQ in 3Q23, but a continued recovery remains elusive. According to CBRE, office net absorption recovered 60% QoQ in 3Q23 from a low base but remained weak on a year-to-date basis (the lowest since 2014). Demand in the logistics sector was stable and rental growth stayed positive. The retail sector continued to benefit from tourism tailwinds, increased mobility and resilient household consumption. We expect overall leasing sentiment to stay lackluster in the next 6-12 months given macro uncertainties.

Transaction activity went from bad to worse in 3Q23. According to MSCI (see Figure 1), APAC volumes in 3Q23 tumbled 28% QoQ to USD 25.7 billion, the lowest since 2010. Year-to-date, volume was down 37% YoY in 9M23. Australia (-61%) and South Korea (-57%) transactions fell the most given their rich valuations. Japan (-16%) transactions were among the most resilient due to the favorable yield spread. The headlines on Hong Kong's (-7%) are misleading given the low base. By sector, APAC office (-51%) unsurprisingly fared worst due to negative global sentiment.

Cap rates rose faster in recent quarters but remain insufficient for deal metrics to stack up. Prime asset yields are now mostly above 10-year government bonds but still 1-2ppt below bank financing costs. At the start of the year, the general expectations were for cap rates to peak by late-2023 as it coincided with a reversal in interest rates. With the latter failing to materialize, further price adjustments will be required. In October, Oxford Economics increased their long-term forecasts for 10-year bond yields by 50bps. If this plays out, cap rates may need to go up by a similar extent unless growth picks up correspondingly.

Figure 1: Asia Pacific transaction volume (USD billion)



Source: MSCI, Nov 2023. **Past performance is not a guarantee for future results.**

Focus on the big themes

The financial markets have corrected since the “higher-for-longer” narrative took hold in around September. As of 31 October 2023, US 10-year bond yields rose about 80bps and were up 105bps year-to-date. In APAC, the average increase this year was around 60bps. REIT markets fell further by 13% after the 14% decline over 2022. Among the large markets, Australia (-21%) fared the worst while Japan (-4%) outperformed the others. On average, APAC REITs are trading at a 15% discount to NAV, which implies a 10% asset write-down based on our estimates. By sector, the office sector (-7% to -50%) trades at the widest NAV discount, followed by retail and industrial, while residential is close to parity.

The private markets are still lagging. For example, the private Australia office sector has delivered -10% capital returns over the September 2022-23 period, much more modest compared to the -30% suggested by the REIT prices. That said, the swings in the public markets tend to be magnified due to liquidity. Nonetheless, we think the preference ranking of the listed market broadly mirrors that of the private markets.

Given elevated interest rates, the transaction market could stay lackluster for another 6-12 months. There is further room for cap rates to expand based on a mean reversion to historical spread averages (see Figure 2). 2023 has been a tough year and the lunar year of the dragon does not seem to get any easier. Geopolitical tensions have risen, and the US presidential election could add to the already-long list of risk factors to consider. A projected structural slowdown in China may also have ramifications on the region. We think Investors should stay selective in strong thematic plays.

We expect the office sector to continue its underperformance next year. APAC fundamentals have been more resilient than the US and Europe but lack rental growth to support capital values. South Korea is an outlier but expensive. At the other end of the spectrum, Australia is the weakest market in this region with mid-teens market vacancies. The work-from-home impact is enduring, and more supplies of office space are coming on stream. Better quality assets have done better in tenant retention but ultimately unable to avoid write-downs. To be clear, we expect well-located assets with good amenities to be more defensive and better positioned for the next cycle.

One thing is clear, the capital flow will likely be unfavorable for the office sector. Many managers / owners are starting to make long-term plans to diversify away from this sector. For example, Dexus, the largest office landlord in Australia, aims to have no single asset class at >50% of its total investment portfolio. Office currently makes up 71% of its direct portfolio. Singapore-listed Frasers Logistics &

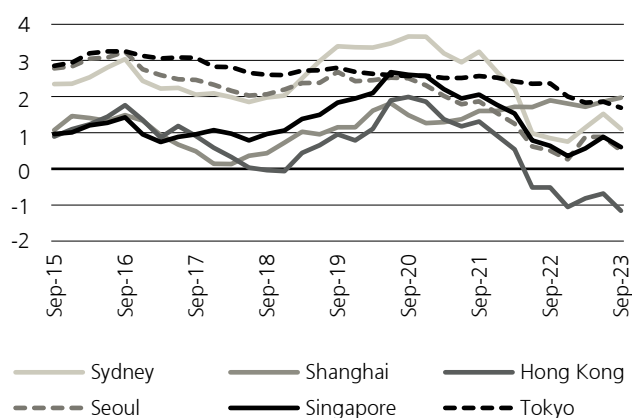
Commercial Trust targets to increase its industrial exposure from 70% currently to 85% in the long term.

We think this trend will be beneficial for sectors with secular growth potential such as the industrial (logistics & data centers) sectors and residential (multifamily) sectors. Rising ecommerce penetration and an undersupply of modern warehouses are key drivers for the logistics sector. This is also in line with a general lifestyle shift to more time spent online, which boosts data consumption. Data centers are the basic infrastructure to facilitate this digital economy with increased demand lately from the proliferation of AI.

Just as online shopping shifted demand from brick-and-mortar retail to warehouses, the hybrid working arrangement has also diverted floor space requirement from office to homes. This trend is already reflected in the transaction mix in the US but less so in APAC given a lack of investable stocks. Australia’s housing shortage situation is severe with no quick fix in sight. The low expected return for the build-to-rent sector has often been cited as a key hurdle so it remains to be seen if the policymaker will provide further incentives. In Japan, multifamily only makes up about 15% of real estate transactions, compared to about a third in the US. This points to significant upside potential for the APAC living sector.

Beyond sector themes, Japan also stands out to offer its unique country theme. Its positive yield spread is well documented. Beyond that, the country is poised to emerge from its three decades of stagnation which drives the expectations for monetary policy normalization. This should improve rental growth potential and change fundamental assumptions for the first time in ages. In addition, the country is also attractive from a currency perspective. Investors could either lock in a safe hedging gain of 4% vs US Dollar or take a risky bet if they are with the hawks.

Figure 2: Prime office yield spread over 10Y bonds (%)



Source: CBRE, PMA, Oxford Economics, Nov 2023. **Past performance is not a guarantee for future results.**

US real estate

Looking for respite



A critical juncture

“Downturns are rare in private commercial real estate, but repricing and reduced buyer pools create opportunities for investors willing to accept more risk today for higher reward during recovery.”

Tiffany B. Gherlone

Head of Real Estate Research & Strategy – US



Navigating uncertainties

High interest rates and economic uncertainty continued to weigh on commercial real estate markets during 3Q23. According to the National Council of Real Estate Investment Fiduciaries (NCREIF) Index, total annual returns fell by 8.3% in the year ending 3Q23, due to capital returns which were -12.1% over the trailing year. The quarterly pace of depreciation decelerated in 3Q23 but was still weighed down by office sector write-downs.

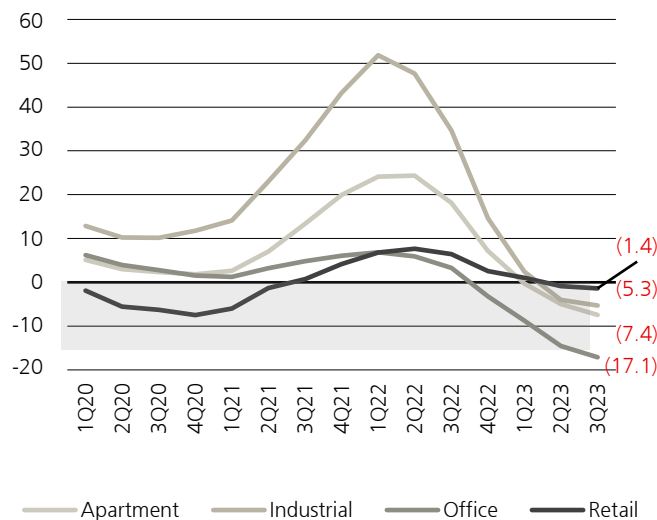
Retail produced the highest relative return among the major property sectors, as stabilized retail in prime locations with strong tenancy face little competition from new supply (see Figure 1).

Despite capital market headwinds, operating results continue to be generally positive. Across core real estate, net operating income (NOI) grew 4.2% in the year ended September 2023, according to NCREIF, outpacing headline inflation by 50 bps. Retail occupancy rates rose during the quarter, while industrial and apartment occupancy rates dipped slightly but remained near 95%.

US transaction volumes, which saw a 53% decline in 3Q23 compared to a year ago, are expected to remain muted until debt availability improves. During the first half of 2023, total commercial and multifamily mortgage originations were 54% lower than the same period in 2022 (source: Mortgage Bankers Association). A Fed survey of senior loan officers shows bank underwriting standards for commercial real estate loans near historic highs and are expected to remain tight into early 2024 (see Figure 2).

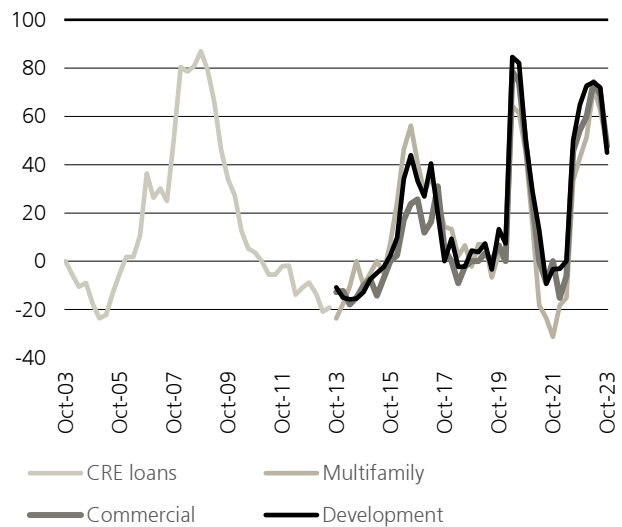
Downturns are rare in private commercial real estate. With only 20 negative quarters out of 183 quarters of NCREIF data, total returns were positive about 90% of the time. Periods of depreciation are difficult, but repricing and reduced buyer pools create opportunities for investors willing to accept more risk today for higher reward during recovery. Sectors with the highest rent growth and lowest capex burdens, like Industrial, Residential and Self-Storage, should see the fastest return to positive cash flow and increased buyer interest when conditions improve. Current market dislocation offers a rare opportunity to improve portfolio diversification by adding niche property sectors at a discount to historical pricing.

Figure 1: Annual total returns (%)



Source: NFI-ODCE Performance Attribution, 3Q23 Preliminary Property Detail Report. **Past performance is not a guarantee for future results.**

Figure 2: Percent of Large Banks Tightening CRE Loan Standards (%)



Source: Board of Governors of the Federal Reserve System as of October 2023. Note: CRE loans series was discontinued and broken up into new categories in July 2013. **Past performance is not a guarantee for future results.**

Primary sectors – standout

Figure 3: October US real estate return forecasts

Total return (%)	2020	2021	2022	2023 forecast	3-year forecast
Apartment	1.8	19.9	7.1	(6.6)	2.2
Industrial	11.8	43.3	14.6	(4.5)	1.8
Office*	1.6	6.1	(3.3)	(15.4)	(4.9)
Retail*	(7.5)	4.2	2.5	(1.4)	3.5

* Office and Retail forecasts were taken from PREA. PREA forecasts are more consistent with UBS Research & Strategy’s outlook for a slow and steady recovery in the office sector, and resilient performance in the retail sector. Oxford Economics office forecasts are -12.2% in 2023 and -1.0% over a three-year annual average. Oxford Economics retail forecasts are -4.4% returns in 2023, and 2.6% over a three-year annual average. Source: Oxford Economics Forecasts for apartment and industrial sectors, as of 11 October 2023. PREA forecasts for office and retail, as of August 2023. Total return: NCREIF, as of November 2023. Data shows unlevered NCREIF Property Index total returns. **Expected / past performance is not a guarantee for future results.**

The apartment sector

The apartment sector demand continued to rebound in 3Q23, but soaring supply weighed on rent growth. Apartment completions rose to the highest quarterly level in over 30 years, outpacing demand and driving occupancy rates down by 10 bps over the quarter and 120 bps over the year to 94.9%. Year-on-year asking rents increased marginally by 0.7% in 3Q23, compared to 10.3% just a year ago. Transaction volumes fell moderately over the quarter by 5.7% and remained 61.7 % below 3Q22 levels. The apartment sector delivered an annual total unlevered return of -7.4% in the year ending 3Q23, due to a continued drag in capital returns. We expect another write-down this year, before values begin to stabilize next year (see Figure 3).

The industrial sector

Industrial markets posted sluggish demand levels in 3Q23 despite continued strength in rent growth. Demand slowed from the previous quarter and hovered below pre-pandemic levels as economic uncertainties weighed on leasing activity. New deliveries stayed elevated and pushed the availability rate up by 50 bps over the quarter and 170 bps over the year to 6.4% (see Figure 4). Despite a softening in market fundamentals, industrial rents continued to soar by 9.6% YoY in 3Q23. Transaction volumes remained slow during the quarter, down 12.0% from a quarter ago and down 45.5% from a year ago. The sector’s annual total unlevered return was -5.3% in the year ending 3Q23, as values declined for the fourth consecutive quarter. We expect further depreciation this year, and very moderate value write downs in 2024.

The office sector

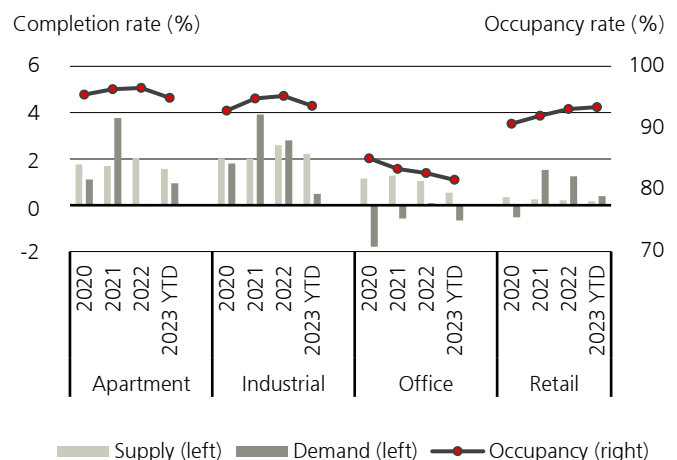
The office sector fundamentals continued to weaken in 3Q23, but demand is starting to show preliminary signs of stabilizing.

Net absorption stayed negative for the fourth consecutive quarter but showed meaningful improvement from last quarter’s decline. Subleasing activity fell by 27.0% over the quarter, signaling a gradual recovery in sector fundamentals. The pace of new deliveries remained subdued and was 25.1% below the five-year historical third quarter average. Office occupancy rates fell by 20 bps over the quarter to 81.6%, marking the lowest rate in over 30 years. Interest rate hikes and challenges facing the sector continued to drive sluggish transaction activity. Transaction volume was 24.6% below last quarter’s volume and 65.0% below 3Q22 levels. The office sector delivered an annual total unlevered return of -17.1% in the year ending 3Q23, driven by capital returns which dipped -21.1% during the same period. Though we expect values to depreciate through 2024, we expect these quarterly write-downs to be less severe moving forward.

The retail sector

Demand in the retail sector remains steady, while the pace of supply continues to diminish, driving growth in both occupancy and rent. Demand outpaced supply for eleven straight quarters and drove occupancy rates up by 10 bps over the quarter and 50 bps over the year to 93.4%. Occupancy reached the highest rate in 3Q23 since it started being tracked by CBRE in 2005. Transaction volumes accelerated over the quarter by 36.6% but remained 30.5% below 3Q23 levels. Retail returns declined the least among the four property types, posting a -1.4% total annual return in the year ending 3Q23. We expect retail returns to rebound in 2024 and outperform the other sectors through 2025.

Figure 4: Sector fundamentals



Source: CBRE-EA, as of September 2023, Apartment Occupancy is Real Page as of September 2023. Note: Completion and absorption rates shown are the total supply delivered and absorbed within the year as a percentage of inventory. **Past performance is not a guarantee for future results.**

Selected niche sectors – moderating expectations

Self-storage¹

Self-storage fundamentals continued to soften during 3Q23 as many REIT 3Q23 results show slowing net operating income (NOI) growth. Interest rates have continued to increase, decreasing the mobility of the consumer. At the same time, new supply and rent increases have brought down occupancy rates to pre-pandemic levels. During June 2023, surveys showed customers looking for more space made up the largest share of self-storage users. This is compared to a year earlier when consumers who were moving or downsizing made up the majority of demand.

Move-in rents declined by an average of 15% during 3Q23 and occupancy across REITs averaged approximately 92% during 2Q23. Despite this, expense growth remained moderate at 3% during the last year and is expected to remain around this level going forward. Growth in NOI is expected to be flat for the remainder of 2023 before picking up during 2024. Supply remains the largest headwind for asset values and NOI growth, but the pipeline has been restricted due to tighter lending standards and higher input prices.

Overall sector fundamentals will likely continue to soften until 2024 as consumers adjust to higher interest rates and deteriorating economic conditions. However, high mortgage rates will lead to a reduction in consumer space as they are priced out of larger, more expensive homes. Historical data shows this will lead to long-term increases in income returns, presenting an opportunity for discounted buys.

Cold storage²

Cold storage operating results for 3Q23 came in slightly below expectations after two quarters of outperformance. Americold, a global cold storage REIT that holds 86% of its inventory in the US, reported a 345 bps YoY increase in economic occupancy to 84.0%, a record for third-quarter occupancy.

Although food production has slowed, increased consumer spending on food and food flows for goods that utilize cold storage has likely pushed occupancy rates higher. Higher occupancy supported same-property (SP) revenue, which grew by 9.1% YoY. At the same time, SP operating expenses declined, contributing to SP NOI increasing by 10.4%. Third quarter results are benefiting from moderating inflation rates, but NOI and occupancy growth will likely moderate alongside consumer spending.

Senior housing³

The senior housing sector – defined as the combination of the majority independent living and assisted living property types – continued to make positive gains in 3Q23. Occupancy rates in primary markets rose by 80 bps to 84.4%, marking the ninth consecutive quarter of occupancy increases.

While occupancy rates are 660 bps above the pandemic-driven trough, they are still 270 bps below pre-pandemic levels. Solid recovery during the quarter was driven by strong demand paired with slow inventory growth. Quarterly net absorption was 1.1% of total inventory, outpacing new deliveries at just 0.4%. We expect a muted supply pipeline to support further improvements in sector fundamentals.

Life sciences⁴

Life science fundamentals softened during 3Q23, despite stable capital funding. The vacancy rate rose by 1.5% over the quarter to 10.6%, above the 8% average rate between 2016 to 2020. The rapid increase in vacancy rates resulted from both a 1.3% increase in supply and a 0.8% decrease in absorption. Life science employment growth also slowed to 1.4% YTD, slightly surpassing the 1.0% increase in total US non-farm employment.

Despite a slowdown in market fundamentals, capital funding saw some improvement. Venture capital (VC) funding, a major driver of demand, rose for the second consecutive quarter and reached a level on par with the quarterly average seen in early 2020. We expect the supply pipeline, which remains elevated with 19.5% of stock currently under construction, to weigh on market fundamentals over the near term, even as capital funding picks up again.

Source: **1** GreenStreet, as of October 2023; **2** Americold Company Report, as of 3Q23; **3** NIC Map, as of October 2023; **4** CBRE, as of October 2023.

Tempering

Economic viewpoint

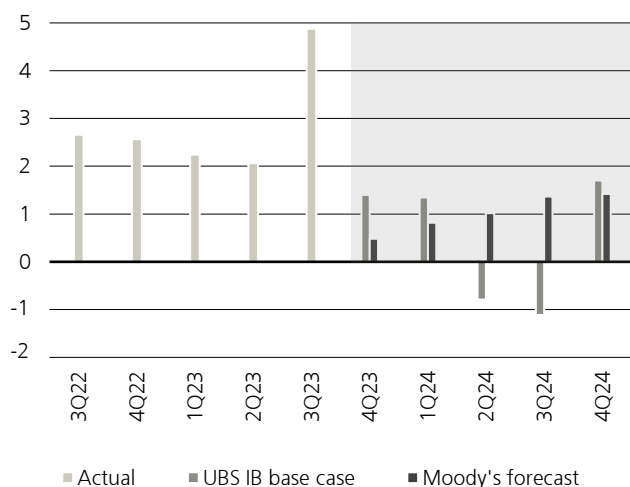
Real GDP grew above consensus forecasts at a 4.9% annualized rate during 3Q23; yet economic forecasts are still divergent in the short term (see Figure 5). The sharp acceleration in growth was driven by strong consumer spending, which contributed 2.7% to GDP growth, and a rise in inventory accumulation, which contributed 1.3% of GDP growth.

Residential investment increased by 3.9%, while non-residential investment declined by 0.1%, with both contributing just 0.2% to GDP growth. Business spending on structures eased after the initial growth surge following the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act. Consumers continue to be the main contributor to strong economic growth, but savings rates have declined to historic lows. Tight credit conditions will likely cause consumer demand to moderate.

Non-farm payroll employment posted a 150,000 increase in October, below consensus expectations. The job numbers from September and August were also revised down by a total of 101,000 jobs. Combined with moderating wage growth, this gives the Fed a clearer picture of a softening labor market. The unemployment rate increased slightly to 3.9% and the labor force participation rate edged down to 62.7%. Employment in the services sectors increased by 110,000, led by health and education increasing by 89,000.

The Federal Reserve held rates steady during the November meeting as policymakers grappled with whether current financial conditions are tight enough to manage inflation. Both UBS Investment Bank and consensus forecasts anticipate steady interest rates through the year end, as already record-high interest rates and diminishing consumer purchasing power work to slow the economy. However, Federal Reserve Chair Jerome Powell, indicated that they would be prepared to raise rates again if progress on inflation stalls.

Figure 5: Real GDP quarterly annualized forecast (%)



Source: Actual Moody's Analytics, as of 11 October 2023; UBS Investment Bank forecast, as of 1 November 2023. Note: Shaded area indicates forecast data. **Past performance is not a guarantee for future results.**

Economist expectations for the short term are quite different, but most predict a slowdown with varying degrees of severity over the next few quarters. However, continued economic growth after the brief slowdown is consensus. Reduced savings rates from consumers with slowing disposable income mean that consumer purchasing power is not likely to continue growing, but this has been the story for several quarters and is reflected in the disparity in forecasts.

In our base case, cumulative GDP is forecasted to increase by 2.5% in 2023, but with contractions starting in 2Q24 through 3Q24. If core PCE continues to moderate, the economic decline will likely be brief as described. Growth is expected to rebound during 4Q24 and continue through 2025, following a reduction in the restrictiveness of the Federal Reserve policy. Although our base case is a hard landing, a streak of resilient economic data has raised the probability of a soft landing.

Sustainability

The green building premium



Green building premium

“Our research finds clear evidence of a green premium in the two largest office building markets, New York and London, driven by tenant requirement and legislation. This highlights the importance to property owners of incorporating and considering the sustainability impacts of their buildings into their overall approach.”

Yiling Chen

Sustainability Specialist, Real Estate & Private Markets

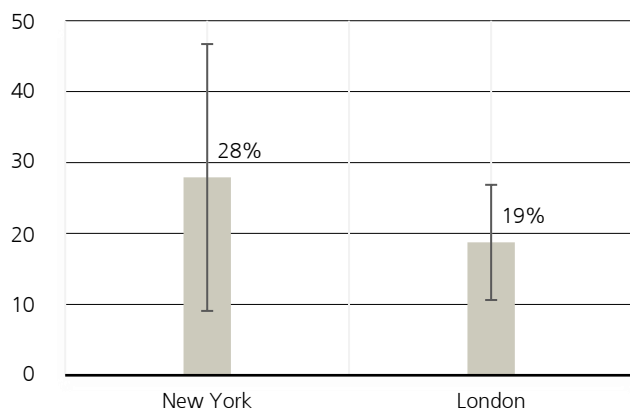


Certified buildings drive value in New York and London

There is consensus around the existence of a green premium, although it should be noted that many studies were conducted pre-pandemic. Our research examines 1,453 office building transactions in New York and London between 2010 and 2022, running a regression to analyze the economic implications of environmentally certified commercial real estate while controlling for a wide range of factors.

On a price per square foot basis, New York and London see material green premiums of 28% and 19% respectively (all else being equal; ie. location, age, renovation, occupancy, and lease length – see Figure 1). This relationship aligns with the findings of a recent report by MSCI – based on London transactions – which found a 25% or higher gap in sale prices for those with a sustainability certification from BREEAM than those without (Leahy, 2022). This is supported by BREEAM’s finding that developers of certified buildings reported sales prices up to 30% higher vs. non-certified buildings, and value retention was indicated as a main benefit of certification by 38% of surveyed property owners (Soulti and Leonard, 2017).

Figure 1: Green price per square foot premium (%)



Source: RCA, Walkscore.com, USGBC, BREEAM, UBS Asset Management, Real Estate & Private Markets (REPM), 2010-2022.

Further, green premium is consistently positive in 90% of the transactions in New York and London implying even at the lower end certified buildings trade above non-certified. A stable green premium in London, as indicated by narrow confidence interval, implies wide market acceptance.

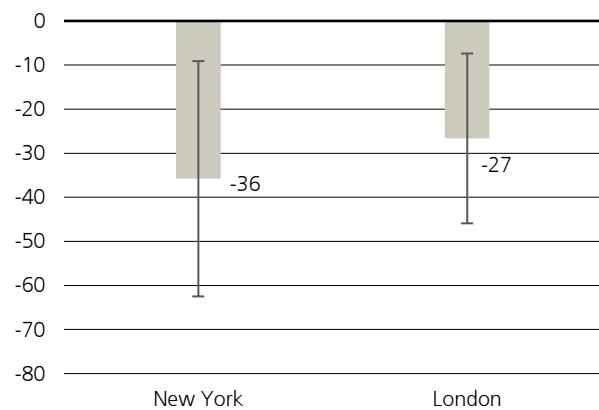
There are numerous factors which can contribute to a green premium, but a key one is net zero commitments. As of June 2023, around 149 countries had announced net zero targets, covering close to 88% of global emissions (Net Zero Stocktake, 2023). As real estate drives approximately 39% of total global emissions (McKinsey, 2022), it is logical that countries and companies alike will focus on real estate as a critical way of reducing their footprint.

A recent example of this is HSBC who are set to move their London headquarters. While there were other factors involved, HSBC specifically stated the move to a smaller and sustainable office would help them meet their net-zero commitments (Quinio and Croft, 2023).

Certified buildings reduce risk in New York and London

From Figure 2, we can see that on a yield basis, certified offices trade 27bps and 36 bps tighter than non-certified buildings in urban areas of London and New York, respectively, assuming that all else is equal; ie. location, age, renovation, and occupancy. This can be reaffirmed through various studies which have confirmed rental premiums between 5-15% (LaSalle, 2023).

Figure 2: Green cap rate spread (bps)



Source: RCA, Walkscore.com, USGBC, BREEAM, UBS Asset Management, Real Estate & Private Markets (REPM), 2010-2022.

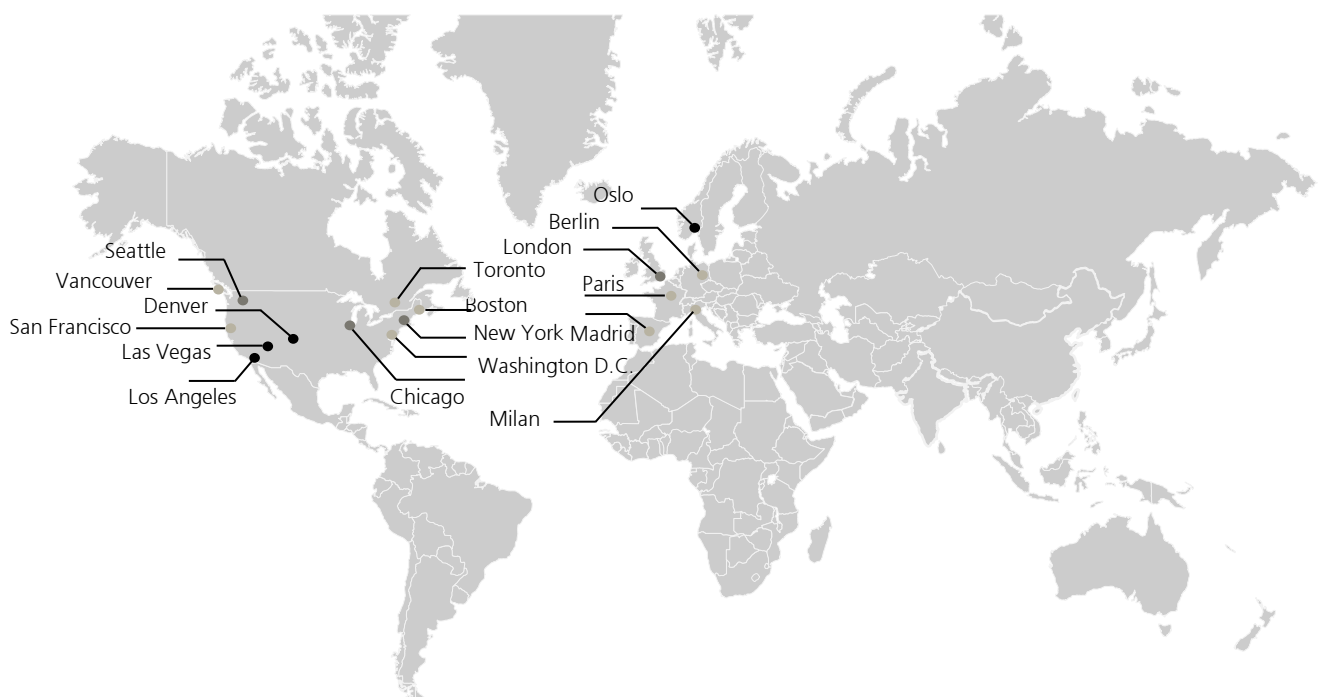
As an EY report nicely summarised, green buildings have proved to reduce risk and create superior exit opportunities for investors. By lowering legislative and obsolescence risk, capitalization rates are compressed, thus creating market premiums (Johnson, 2022).

An additional way to explain the trends highlighted in the graph is to look at “non-green buildings”. As detailed further below, the legislation and net-zero requirements are greatly increasing the chance of “non energy efficient buildings” becoming stranded assets – assets that suffer from unanticipated or premature devaluations. To alleviate this risk, a property can be retrofitted to meet required environmental standards.

However, this is an immensely expensive process. Research from JLL estimates that the cost of retrofitting the office and shopping mall stock across 17 major countries to be close to USD 3 trillion (Bolino, 2022). As a result, investors demand a heavy discount to consider investing in these “non-green buildings”, meaning higher capitalisation rates to reflect that risk and future costs.

Tenant requirements and legislation propel the shift

Figure 3: Annual emission reduction implied by interim targets – North America & Western Europe



Carbon reduction to meet respective target

- 5% or above
- 4%
- 3% or below

Source: Net Zero Tracker, UBS Asset Management, Real Estate & Private Markets (REPM), November 2023

Tenant requirement

Various studies have confirmed rental premiums between 5-15% for properties with 'green features' across different regions (LaSalle, 2023). Indeed, a recent ESG survey by CBRE reveals that over 60% of Continental European investors and occupiers are willing to pay more for building features that reduce carbon footprint and improve health and well-being of employees (CBRE, 2023). Globally, 73% of public companies and 37% of private companies have set emission targets, according to an analysis by CDP and Bain (Lino, Doolan, Divgi and Mehrotra, 2022).

With real estate responsible for 39% of total global emissions, getting their real estate footprint right is critical for those companies with net-zero commitments. Growing pressure from investors and customers alike only heighten the need for companies to seek out buildings with strong sustainability credentials.

Legislation

On regulation the direction of travel is clear. There has been a significant acceleration in net-zero emissions pledges announced by cities, with an increasing number enshrined in law. In the United States, 73% of major cities¹ have committed, in law or policy document, to zero emissions by 2050. In Western Europe, 65% has done the same². These cities have set interim targets to reduce emissions ranging from 1% to 6% every year through 2030 (see Figure 3). Note that these figures conservatively exclude cities that have made a pledge but haven't laid out the plan. If legislation progresses as expected, then buildings will have to have materially progressed their decarbonisation efforts to remain compliant.

Legislation is not only the enforcer but also the enabler. One of the challengers to this transition has been the substantial upfront costs, exacerbated by inflation, associated with retrofitting existing buildings to meet sustainable standards. However, the tide seems to be changing as governments worldwide have rallied to provide unprecedented financial support. Taking the US as an example, the 2022 Inflation Reduction Act represents the biggest clean-energy incentives in US history, six times the size of the 2009 stimulus bill (Mufson & Kaplan, 2022).

If these regulatory levers succeed, we will see 'green' real estate becoming the norm. From the perspective of an asset manager or property owner, whether legislation continues to drive premiums, or a low-performing discount emerges, it does not matter. In either situation returns will be sacrificed if the asset manager / property owner does not account for the environmental impact that a building has.

¹ Major city = city with a population greater than 500,000. 22 out of the 37 major US cities have committed to net zero. Source: Net Zero Tracker
² Western Europe cities with a population greater than 500,000. 18 out of the 35 major European cities have committed to net zero. Source: Net Zero Tracker



Infrastructure

Deglobalization –
an underappreciated tailwind



Deglobalization is often misunderstood

“At first glance, *deglobalization* appears to carry a negative connotation, but the truth is, it is very positive for infrastructure, as the onshoring of manufacturing capacity and the increased focus on energy security will require significant infrastructure investments.”

Alex Leung

Head of Research & Strategy, Infrastructure



Deglobalization – an underappreciated tailwind

Earlier this year, we highlighted “deglobalization” as an important megatrend that will support private infrastructure investments ([link](#)). On the surface, “deglobalization” may carry a negative connotation, as it has historically been seen by the global business community, as negative to business.

But this is no longer the case. After the world experienced severe supply chain disruptions during the COVID-19 pandemic, and the increased demand for energy security after the start of the war in Ukraine, localization of supply chains and energy self-sufficiency have become priorities for countries around the world. Deglobalization, in other words, is simply good business.

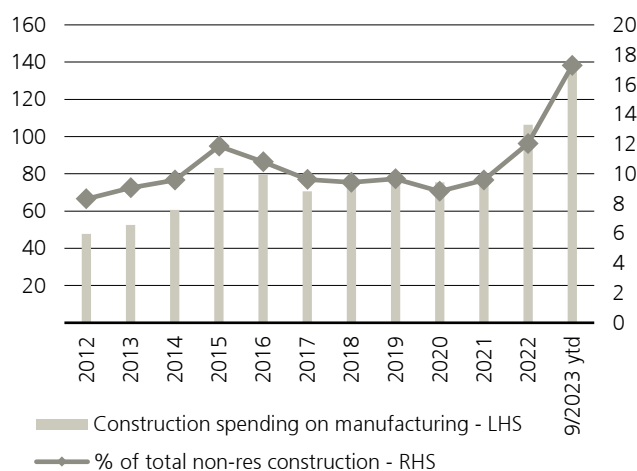
The truth is, deglobalization is actually positive for infrastructure, as onshoring of manufacturing capacity and increased focus on energy security will require significant infrastructure investments.

Tracking manufacturing investments

The macro data is beginning to reflect this trend. US construction spending for manufacturing reached a record high of over USD 100 billion in 2022, after being stagnant for six years. This has further accelerated in 2023.

In the first seven months of 2023, this has already exceeded the USD 100 billion mark. As of September 2023, manufacturing investments in 2023 have already reached USD 140 billion, a 70% YoY increase and accounting for 18% of total construction (see Figure 1).

Figure 1: US construction spending in manufacturing and share of total non-res spending (USD billion)



Source: US Census Bureau, October 2023. **Past performance is not a guarantee for future results.**

Government policies have a big role to play here. The US Inflation Reduction (IRA) Act and the Creating Helpful Incentives to Produce Semiconductors (CHIPS) Act have

incentivized the build out of domestic clean energy and semiconductor supply chains.

Many large corporates across the technology and industrial sectors have already announced multi-billion-dollar manufacturing facilities in the US in the last two years (see Figure 2). The list below is by no means comprehensive, as the US government is tracking almost USD 500 billion of private sector manufacturing investments.

Even if some of these projects do not materialize, the magnitude of the investments will still be staggering. Many large corporates are also targeting smaller cities or more rural regions, which has the potential to revive the US industrial heartland.

Figure 2: New US manufacturing projects announced since 2021

Company	Location	Investment (USD billion)
TSMC	Phoenix, AZ	40.0
Texas Instruments	Sherman, TX	30.0
Intel	Chandler, AZ	20.0
IBM	Hudson Valley, NY	20.0
Micron	Clay, NY	20.0
Intel	Licking County, OH	20.0
Samsung	Taylor, TX	17.0
Micron	Boise, ID	15.0
Texas Instruments	Lehi, UT	11.0
Hyundai Motors, LG	Pembroke, GA	7.6
Stellantis, Samsung	Kokomo, IN	6.3
Nacero	Penwell, TX	6.0
HIF Global	Matargorda, TX	6.0
Ford, SK Innovation	Glendale, KY	5.8
LG Energy	Queen Creek, AZ	5.6
Ford, SK Innovation	Stanton, TN	5.6
Rivian	Madison, GA	5.0
Hyundai Motors, SK	Bartow County, GA	5.0
Wolfspeed	Pittsboro, NC	5.0
Pier Wind	Long Beach, CA	4.7
Air Products	Ascension Parish, LA	4.5
Applied Materials	Sunnyvale, CA	4.0
Panasonic Energy	De Soto, KS	4.0
GM	Orion Township, MI	4.0
VinFast	Chatham, NC	4.0

Source: White House, Press Releases, UBS Asset Management, November 2023

This is not just a US phenomenon. Europe is also tracking over USD 200 billion of electric vehicle and battery investments¹, and over USD 100 billion of semiconductor investments². Maros Sefcovic, who is leading the efforts behind the EU green deal, recently said that the EU will take on a more assertive approach in promoting “made in Europe” green industries³, as a response to the pro-manufacturing policies set out by the US IRA.

A greener industrialization

One issue that is often associated with reshoring is the environmental impact, as the word “industrialization” often evokes the image of smoke, soot, and grime of the Victorian era.

In our view, this will not be the case. The current reshoring trend simply moves energy consumption from one country to another. It does not increase overall energy demand in the world, as this is a supply driven trend. In addition, it also reduces emissions from long-haul transportation.

Looking at the list of companies that are driving this build out of this new manufacturing capacity (see Figure 2), most of them are large corporations that have also made net zero commitments. This means the new factories will likely source cleaner energy and focus on energy efficiency and sustainability.

For example, Intel, which is looking to invest over USD 100 billion in US and Europe chip-making plants, has pledged to achieve net-zero greenhouse gas emissions in its operations by 2040. TSMC, another major chip maker, has committed to reaching net zero emissions by 2050.

Finally, many of the new manufacturing investments are focused on clean energy technologies such as electric vehicles and energy storage. The ramp up of these facilities will only further enable the energy transition to continue.

The opportunity for infrastructure investors

With deglobalization, the obvious opportunity for infrastructure investors are local transportation and logistics assets, as demand for domestic and regional transport networks should increase with more goods being produced locally. But opportunities extend beyond this.

We are seeing a revitalization of old industrial heartlands, which means a potential acceleration in economic and population growth across previously underinvested and overlooked regions. A large semiconductor producer simply will not commit 10s of billions of dollars into high tech manufacturing, without certainty around energy supply, utility services, and high-speed internet access. This widens the investable universe for infrastructure across almost all sectors.

Private infrastructure sector performance outlook

	Negative	Neutral	Positive
Europe	Oil & gas, utilities	Toll roads, ports, conventional power	Airport, railroads, logistics, fiber, telecom towers, data centers
US	Utilities	Oil & gas, toll roads, ports, conventional power, data centers	Airport, railroads, logistics, fiber

Source: UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Assessment informs top-down perspectives by sectors and regions. REPM will weigh the perceived relative attractiveness using a scale of “positive”, “neutral” and “negative” ratings. The ratings do not reflect exclusionary or inclusionary investment screening but imply more risk premium to be applied to sectors with “negative” ratings and less risk premium for sectors with “positive” ratings, based on our latest views. These ratings are the opinion of REPM and may not necessarily provide an accurate reflection of the ultimate success or potential return of a given strategy. **Past / expected performance is not a guarantee for future results.**

¹ https://www.atlasevhub.com/data_story/210-billion-of-announced-investments-in-electric-vehicle-manufacturing-headed-for-the-u-s/

² <https://europeannewsroom.com/europe-in-brief-eur-100-billion-of-investments-planned-in-european-chip-industry-announces-thierry-breton/>

³ <https://www.bloomberg.com/news/articles/2023-10-12/eu-to-push-made-in-europe-tag-in-green-industry-sefcovic-says>



Food & Agriculture

From farm to fork

Food security

“Investors, farmers, scientists, governments, food companies and citizens need to come together. Collaboration with each link in the food value chain is essential. Through harnessing the collective power of these stakeholders, we can foster a collaborative environment that accelerates positive change, and better food security.”

Darren Rabenou

Head of Food & Agriculture



Investment to support scale

Rising commodity prices, risk of food shortages, as well as the lingering impact of the pandemic, have triggered a concern for the availability and accessibility of food around the world. To alleviate the growing threats to global food security, more food infrastructure investment that supports scale is required. While there are many routes to success, investors play an important role in providing much-needed capital that can bring down the cost of food at scale. The entire food value chain, from farm to fork, is a significant driver of a country's GDP, with the US.

Department of Agriculture stating that agriculture, food and related industries contributed USD 1,264 trillion to US. GDP in 2021, or around 5.5%. Food, and specifically food prices, possibly have a bigger impact on the global economy than this figure suggests, as it tends to be a disproportionate contributor to inflation, especially in developing countries.

Certain links in the food value chain are capital-intensive to run and present an opportunity for investment to significantly enhance the efficiency, and security, of food production. *According to the World Resources Institute*, one-third of all food produced globally by weight is lost between farm and fork. Consequently, investors who focus on the more capital-intensive side of food investment can have a big impact on global food security and affordability for consumers.

Sustainable farmland management and ingredient sourcing standards, such as *Leading Harvest*, of which UBS Asset Management is a founding member, helps investors work together with farmers to establish these key practices. These standards will eventually be adopted in other markets (including developing countries) that supply critical food commodities to global consumer food companies. Whether it is sustainably sourced cocoa for chocolate production, soybeans or coffee, developing countries will have to start addressing issues such as water conservation, deforestation and fair labor practices if they continue to supply developed market consumers.

When looking at food infrastructure, such as temperature-controlled food processing and cold storage facilities for refrigeration, there is a significant opportunity to improve efficiency through investment. Improved food infrastructure can help reduce food waste, ensure availability of perishable goods year-round, support resilient supply chains and ultimately enable lower food costs to end-consumers. Food waste makes upwards of 25% of landfill and is a disproportionate negative CO₂ contributor as well.

The average cold storage facility in the US is between 40 to 50 years old, and many are in dire need of upgraded technology. Yet despite the growing demand for organic or perishable foods such as fruits and vegetables, cold storage has been a relatively under-appreciated infrastructure investment due to the higher build costs and greater specialization of units. In 2021, Acumen Research and Consulting estimated that by 2030 the global cold storage market could be USD 324 billion.

Up until now, investors have largely chosen to focus on high-growth opportunities related to food security and sustainability. Investors have utilized venture capital and opted for experimental ideas, however many of these innovations have struggled to scale, often because the costs of implementation are too high.

Vertical farming, the practice of growing food in vertically stacked layers, was once hailed as a revolutionary solution to enhance food production and security in urban areas. Unfortunately, the industry still needs to demonstrate that its cost of production can be equally competitive to traditional farming. It also has other environmental and scarce resource challenges to overcome.

Cold storage, in comparison, may not be as revolutionary as vertical farming, but reliable facilities to keep food fresh will help ensure accessibility and have a real impact in the fight to reduce food waste and food cost. Infrastructure investment alone will not mitigate challenges to food security. Creating an enabling environment through supportive regulations and incentives for sustainable practices with wider industry collaboration is needed to transform food systems right across the food value chain.

Investors, farmers, scientists, governments, food companies and citizens need to come together. Collaboration with each link in the food value chain is essential. Through harnessing the collective power of these stakeholders, we can foster a collaborative environment that accelerates positive change, and better food security.

A close-up photograph of a hand holding a complex, metallic mechanical gripper. The gripper is composed of various metal parts, including springs, bolts, and a central mechanism. Several bright green wires are attached to the top of the device. The background is a blurred industrial setting with warm, yellowish lighting.

Private equity

An outsized opportunity in secondaries

Navigating an uncertain market

“The uncertain macroeconomic environment is weighing on private equity dealmaking and exit timelines (but so far not on realized returns). Proven sponsors and strategies continue to attract capital, and nimble, reputable investors are seizing the opportunity to access funds, and transactions have been closed-off in recent years.”

James Pilkington

Multi-Managers Private Equity, Portfolio Manager



Macro weighs on dealmaking and timelines

Venture capital weathers a storm

It has been a tough year for venture capital (VC) funds and venture-backed companies (see Figure 1 and 2). While the collapse of Silicon Valley Bank and First Republic (two stalwarts in the world of startup banking) started things off on a grim note, the event ultimately passed without too much direct disruption. One reason is that it was already becoming more difficult for startups to secure capital, particularly for more speculative companies without proven product-market fit and a clear path to positive unit economics.

This view is now mainstream among venture capitalists who see a longer path ahead for their new investments. For investments which have already been made, VCs are digging in their heels, with many reluctant to see a “down” financing round at a lower valuation which could impact their holding values. There are mixed views among market participants (companies themselves, VCs, and investors in VC) as to whether it is healthier to delay new funding rounds or continue business-as-usual, but with lower valuations.

Proponents of delaying further rounds would like to see companies conserve their existing capital; so far, this group seems to be winning, with the difficult tech labor market as a proof point. But there is another, growing group, which believes companies have to “take their medicine” with down rounds if the market is to reach its new normal. Anecdotally, we believe this camp is growing and will win out in the year ahead. That will ultimately produce a healthier market and open the door for an eventual resurgence in venture capital – at the price of some near-term pain.

Based on these dynamics and in spite of some multiple reflation in the technology sector, we see a difficult 2024 ahead for venture capital, but believe in the long-term appeal of this investment stage which occupies an attractive place in the value chain. There may be opportunity sooner than expected, particularly if the upstream (VC fund investor) pullback becomes too extreme. That opportunity could even be found outside the usual Silicon Valley darlings. European VC recently outperformed US VC for the first time in 20 years¹.

Buyouts, less leverage

Today’s market is one of the most challenging for buyouts since the financial crisis but is also presenting real opportunities for sponsors to differentiate themselves in the industry and for their companies to pull away from their public peers (who are very conscious of quarterly earnings in the current market environment).

The increased cost of leverage puts downward pressure on returns for companies which have to finance at such rates for substantial portions of their holding period. As investors, we believe our primary defense against this unfortunate reality is vintage-year diversification, as we expect companies will course-correct their capital structures rather quickly once conditions in debt markets improve. Limited debt availability is creating a greater flow of co-investment than has been seen for many years, and LPs are taking advantage of this to optimize returns in their own portfolios, with the best deals often accruing to LPs with established multi-generational relationships with their in-portfolio sponsors.

With respect to fundamentals, operating conditions for private companies are largely unchanged: particularly in the US, labor costs are a recurring concern among management teams, and we see parallels in the broader economy with many successful high-profile strike actions, most recently involving the automobile industry. Consumer spending power is so far a bright spot which continues to propel the US market. Observers note that there is still USD 1 trillion of excess savings² (which, previously, was thought to have been spent).

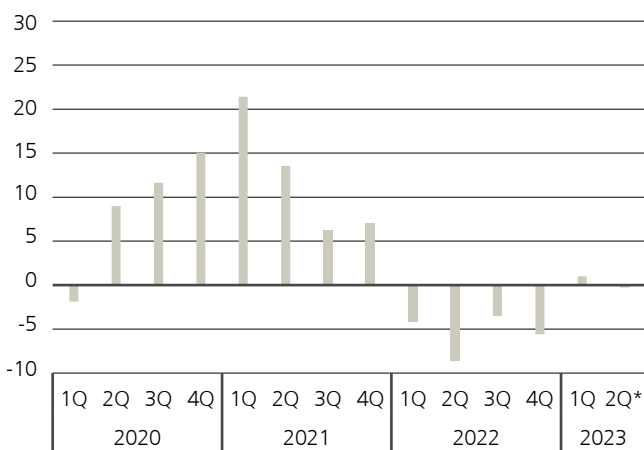
Sentiment in Europe, which lacks this supportive cushion, is less robust.

Against this backdrop, funds and companies pursuing proven business models with prudent capital structures and solid operational value creation plans remain our top choice today.

¹ Pitchbook, November 2023

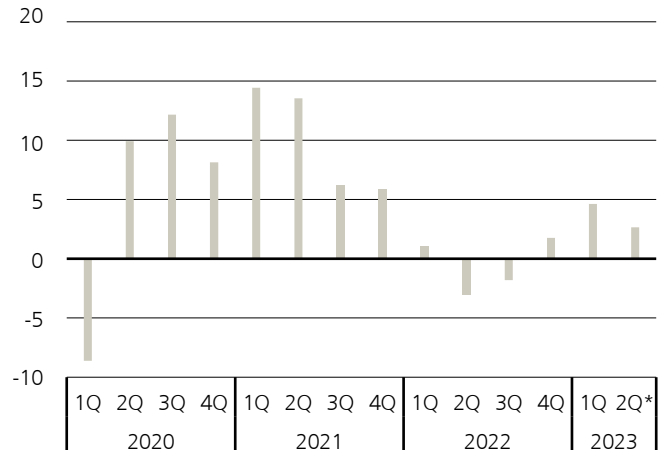
² *Bloomberg*, October 2023

Figure 1: Venture capital quarterly fund returns (%)



Source: PitchBook, November 2023. (* denotes preliminary data). **Past performance is not a guarantee for future results.**

Figure 2: Private equity quarterly fund returns (%)



Source: PitchBook, November 2023. (* denotes preliminary data). **Past performance is not a guarantee for future results.**

An attractive market for PE secondaries

We continue to see outsized opportunity in PE secondaries, which can provide increased visibility toward both returns and exit timelines as compared to blind pool fund investments. Favorable secondary-supply dynamics include residual Limited Partners (LP) portfolio balancing (including large portfolios which have taken longer to come to market); increased sponsor need for equity in view of less accommodating debt capital markets; and sponsor-led deals driven by LPs’ desire for liquidity options and unanticipated supportive equity needs.

With the expectation that interest rates will stay higher-for-longer, we believe distribution activity will remain relatively muted. Further, we anticipate that new deal activity will require increased equity contributions by General Partners (GP) and that the LP community will remain under pressure. This will drive a continued flow of LP-led and GP-led secondaries and continuation funds in the market, with a backdrop of favorable terms for secondary buyers through at least late 2024.

Private equity sector performance outlook

	Negative	Neutral	Positive
Americas		Venture capital	Growth equity, buyouts Secondaries
Europe			Venture capital, growth equity, buyouts Secondaries
Asia		Venture capital	Growth equity, buyouts Secondaries

Source: UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Assessment informs top-down perspectives and strategy allocation. REPM will weigh the perceived relative attractiveness of these strategies using a scale of “underweight”, “neutral” and “overweight” ratings. These ratings are the opinion of REPM and may not necessarily provide an accurate reflection of the ultimate success or potential return of a given strategy. **Past / expected performance is not a guarantee for future results.**

Private credit

The growing opportunity set



Quarterly outlook in private credit

“Due to greater macro and economic uncertainty, there is an increased probability of a potential recession and shift in the credit cycle. However, we believe the higher rates and wider spreads offered today compensate investors for the additional credit risk taken.”

Joseph Sciortino

Head Multi-Managers, Private Credit



The growing opportunity set

The opportunity set for private credit remains compelling, as wider spreads, higher base rates and the subsequent market recalibrations have provided attractive entry points across the space. Due to greater macro and economic uncertainty, there is an increased probability of a potential recession and shift in the credit cycle. However, we believe the higher rates and wider spreads offered today compensate investors for the additional credit risk taken. More frequent market dislocations driven by both top-down macro and evolving fundamentals are also creating opportunistic entry points. In this market, we are primarily focused on senior secured strategies with fundamentally strong collateral. With such attractive loss adjusted yields at the top of the capital structure, we see limited need to extend further down the risk spectrum to capture incrementally more returns.

In corporate credit, our core allocations have been to traditional direct lending strategies that focus on first line senior secured loans with strong covenant packages. New post-2021 vintages offer more attractive economics and structuring given rising base rates and a general retrenchment of certain lenders. Capital solutions strategies that focus on more complex or stressed situations also present an attractive risk/reward, as the turning corporate credit cycle and a pull-back in traditional lender activity is creating opportunities for direct lenders. In the distressed area, the opportunity set is not yet compelling as default rates remain near the long-term average. As a result, we will continue to focus on performing credit strategies.

In commercial real estate, our focus remains on short duration lending, as traditional capital providers have retrenched this year. This investment theme has been in multi-family properties given more stable fundamentals

and strong secular tailwinds. Investments have included multi-family bridge-to-agency lending as well as transitional commercial real estate (CRE) lending. These strategies have focused on properties with a high probability of exits via refinancing given the loan structures and property types. The office sector remains a less compelling segment, as the space grapples with challenging secular trends and greater uncertainty on asset valuations. Further distress is likely to develop in the office sector over the coming 6 to 12 months.

Residential real estate lending continues to be a core theme in our portfolios, primarily in the form of partnering with homebuilders to finance short-term acquisition and development as well as land banking strategies. Despite headwinds from rising mortgage rates and declining affordability, we continue to focus on partnerships with high quality homebuilders with deal structuring that includes strong credit enhancements such as the cross-collateralization of projects. Additional exposure to residential real estate also includes mortgage servicing rights, which are negatively correlated to interest rates and have benefited from higher interest rates and slowing prepayment speeds.

In tradable credit, spreads remain somewhat tight relative to historical ranges. However, we continue to actively monitor the credit markets for potential dislocations that provide the opportunity to act as a liquidity provider. Currently, the opportunity set appears more attractive in ABS (Asset Backed Securities) relative to corporate credit, as structured credit markets have lagged the YTD rally seen in corporate credit. We are currently evaluating opportunities but will likely wait for spreads to widen further before adding significantly to tradable credit.

We have upgraded our outlook to neutral for special situations strategies in America and Europe as aggressive central bank regime shifts and looming recessions have begun to create ripple effects. However, dislocations and distress appear to be in early innings as these impacts take time to flow through to markets.

Strategy outlook

Americas and Europe special situations

We have upgraded our outlook to neutral. A looming economic slowdown, persistent inflation, aggressive central bank policy and changing regulatory regimes have started to create market dislocations and forced sale opportunities as market participants recalibrate their risk and return assumptions. However, these dynamics have just started to flow through to the market, and the opportunity set remains in its early stages.

Corporate

We have upgraded our outlook to neutral/positive in America. While the risk of credit events and defaults have increased given rising rates and an economic slowdown, we believe that investors are getting compensated for the additional risks taken due to higher base rates and deal specific enhancements, including tighter underwriting, higher spreads and lender friendly structuring.

In Europe, we continue to hold a neutral outlook. While the opportunity set appears to be improving with rising rates and tightened underwriting, there remains less visibility as to the path of the European economy and there could be greater recessionary pressures in the near term relative to the US. These dynamics could create additional headwinds for businesses, particularly for cyclical, consumer-focused or rate-sensitive industries. The region presents additional geopolitical and macro risk given the war in the Ukraine.

Commercial real estate

We reiterate our current outlook rating in America and Europe. There has been a pullback in lending activity from banks and other lenders. As a result, the team favors first line secured lending opportunities in newly originated deals that have attractive yields and reasonable loan-to-value ratios. In the US, while cap rates have started to reprice, the distressed opportunity set remains in its early stages. Performing properties also present risks as rent growth and NOI will likely face headwinds in a recession. In Europe, distress seems to be in earlier stages, and select COVID recovery themes, such as hotels, appears to be long in the tooth.

Residential

In America and Europe, we continue to hold a positive outlook. In the US despite headwinds on affordability, the sector continues to benefit from strong fundamental tailwinds. This includes a chronic undersupply of inventory post-GFC (Global Financial Crisis), as well as most borrowers benefiting from low Loan to value ratios (LTVs), low locked in mortgage rates and significant Home Partners of America (HPA) growth over the past decade for seasoned vintages. In Europe, select pockets of opportunity also persist, as similar undersupply has resulted in various government programs to support housing stock resulting in attractive guaranteed take outs.

Private credit sector performance outlook¹

	Negative	Neutral	Positive
Americas		Special situations	Corporate, Commercial real estate Residential real estate
Europe		Special situations	Corporate, Commercial real estate Residential real estate

¹ Source: UBS Asset Management, Real Estate & Private Markets (REPM), November 2023. Assessment informs top-down perspectives as well as bottom-up strategy and manager selection. REPM will weigh the perceived relative attractiveness of these strategies using a scale of "underweight", "neutral weight" and "overweight" ratings. These ratings are the opinion of REPM and may not necessarily provide an accurate reflection of the ultimate success or potential return of a given strategy. **Past / expected performance is not a guarantee for future results**

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