Top 10 with...

Eric Byrne on Multi-Managers Real Estate | October 2022

Not for distribution in the US

Key facts:

2007

business established[1]

USD ~26.5bn

invested in equity[1]

150

funds and co-investments[1]

> 1,260

clients[1]

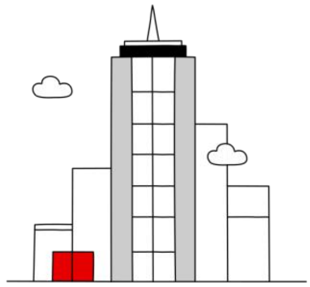
"The way we invest for our clients has significantly evolved such that we are executing bespoke real estate investment solutions for some of the largest and most sophisticated investors in the world."

Eric Byrne, Head of Multi-Managers

A broad investment universe

The multi-manager real estate industry has evolved in recent years with many investors looking for new ways to gain and complement their exposure to global real estate. Eric Byrne explains how the Multi-Managers Real Estate (MMRE) business navigates the current macroeconomic environment to provide greater access to investments with attractive fee savings to clients.

1 What benefits does core real estate offer to a multi-asset portfolio within the current macroeconomic environment?

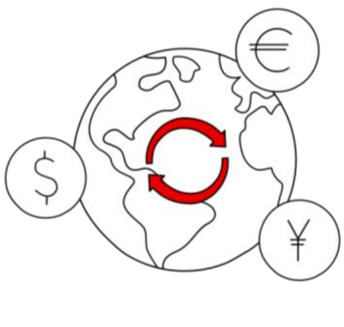


In these times of high inflation, high interest rates, and high volatility, real estate is and will remain attractive due to its relatively high yield, inflation hedge characteristics and comparative stability – which all ensure a relatively low correlation with other asset classes. The lowered volatility stems from the significant income component in total returns (varying from 70-90% depending on the market), driven by the contractual lease structure and the tenant's obligation to pay rent. This can offer a partial inflation hedge, particularly for those assets having shorter leases or those linked to inflation.

There's also a rising risk of stagflation (which occurs when inflation is above average and GDP growth is below average), due to rising interest rates from central banks to try and curb inflation.

In such a recessionary environment, where all asset classes are impacted by lower economic performance, core real estate can act as a stable ballast to a multi-asset portfolio, offering those attractive features I mentioned previously, resulting in better risk-adjusted returns.

2 What about domestic and global real estate investing – Why have both in a portfolio?



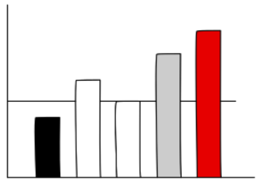
Real estate investors will typically have a home bias to a greater or lesser degree, and understandably so, given it is the market they are most familiar with and in which they probably carry the majority of their liabilities. But adding international real estate to a predominantly domestic portfolio can benefit investors in a number of ways.

Firstly, real estate cycles differ across markets, as is happening now, providing diversification benefits and market entry/exit timing opportunities, which can enhance risk-adjusted performance.

Secondly, expanding into global markets enhances liquidity but also provides investment opportunities by sector, market maturity, or risk profile that might not be available in an investor's home market.

Finally, many investors first assume they need an additional return to compensate for going abroad, necessitating a move up the risk curve. While this might be appropriate for certain portfolios, it is also reasonable to assume that investors should take additional risks in the market they know best, at home, and at least initially expand into best quality, core global real estate.

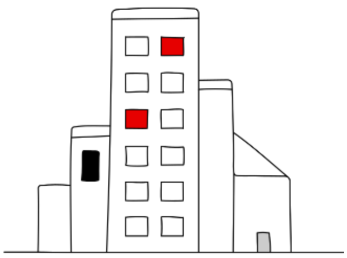
3 What are the options for accessing global real estate?



The evident starting point is the straightforward acquisition of direct properties. However, this strategy implies a certain scale and cost for its implementation, as well as dealing with the complexity of undertaking due diligence in multiple jurisdictions with differing practices, tax, and currencies.
In contrast, gaining exposure via listed securities can be a low-cost alternative to acquire diversified exposure and access expert management without the enormous funds needed for a direct portfolio. Investors also benefit from higher levels of liquidity. The downside is that, in the near-term, these shares are as volatile as the wider stock market. In between direct investment and the public markets lie the unlisted funds, which may be closed-ended or open-ended. They offer a balance between volatility and liquidity, though not all investors may be eligible to invest in them or find them tax- efficient, especially cross-border.

Alternatively, investors could mandate a multi-manager platform, either in a discretionary or advisory capacity, to create their real estate exposure via a product or mandate. Here, rather than investing directly or indirectly through a single unlisted fund, a portfolio can be constructed via multiple routes, such as unlisted funds, co-investments, recapitalizations, and secondaries that are selected by a multi-manager and actively positioned within guidelines agreed with the clients. This removes the concentration risk of being exposed to a single fund (or manager) but adds a layer of fees in recognition of the multi-manager's ability and expertise (and direct time costs) to select and carry out due diligence on investments which are assessed to offer good risk-adjusted returns for a particular strategy. However, the multi-manager can via its scale and pooling, get better access to deal flow and investment terms such as lower fees that help off-set some or all of the double fee layer.

4 How did COVID-19 impact the different property sectors, especially retail and office?



The impact of COVID-19 was and continues to be significant on real estate markets. At the start of the pandemic, the transaction market froze as investors grappled with the crisis and material uncertainty on real estate pricing. Then it soon became clear which sectors would be the winners and losers.

The retail sector was already showing signs of weakness prior to COVID-19, which accelerated its decline. Currently, the total quantum of retail space needed is lower, with now an emphasis on destination retail – which combines shops, leisure, entertainment, and dining.

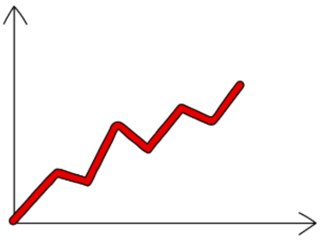
There will also continue to be a demand for local convenience retail and grocery retail. However, large chunks of the retail market have become obsolete, including parts of the high street and lower grade, smaller shopping malls. With the retail sector now largely re-priced, there may be future opportunities repurposing retail premises, or combined with other uses, such as residential and leisure. However, increased inflation and interest rates and the resultant cost of living crisis is providing further headwinds for the retail sector.

As far as the office sector goes, this has been impacted by the partial move to home office – a new setting for many, which has proved to be effective, from both a productivity and a technological perspective. Businesses are now conscious that offering home office to some extent can help attract and retain talent as well as give firms the opportunity to reduce their office footprints and reap some cost savings as lease events occur.

This has triggered a *flight to quality*, which means Grade A offices with strong ESG credentials are still seeing demand, while traditional offices that don't meet these high standards are seeing falls in value, some significant.

So, who are the winners? The logistics sector benefited the most from the accelerated shift to online shopping with large increases in value. The residential sector has also performed well given the demand for rental apartments has consistently outstripped supply. Finally, some of the alternative sectors such as life sciences and data centers have benefited from more investments in biotech, R&D and data capacity.

5 How is rising inflation and interest rates impacting your assessment of real estate?



In periods of high inflation like now, how much of the rental income that can be adjusted in future for inflation needs to be assessed. This typically occurs either within the agreed lease, whereby periodic increases to rent are allowed and inflation linked, or if a property has a short lease period (for example residential properties that typically have a one-year lease), where at the end of such period it is possible to increase the rents to reflect the impact of inflation. So, it is important to assess how much of the inflation can be passed onto the tenants and whether they are willing and able to pay higher rents. Our research team has recently modeled the levels of inflation protection and has shown a 78%[2] protection level.

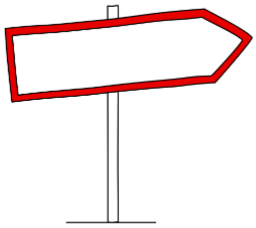
As interest rates rise, so will the cost of debt for real estate owners, who have borrowed money to finance the purchase of the property. A typical core diversified portfolio will have debt of 20-40%, a value-add portfolio will have debt of 40-60% and an opportunistic one 60%+.

It is important to assess how the interest rates rises will impact the debt and over what period of time. Property owners have had the benefit of very low interest rates for a long period of time and many have locked in those low rates. However, the debt maturity will end at some stage and new interest rates will need to be agreed, which will be higher. Property owners also have the ability to hedge against higher interest rates via derivatives.

Therefore, it is important to assess how much of the debt is fixed versus floating, what the maturity of the fixed debt is and what level of interest rate hedges are in place. So, when assessing both existing and potential real estate holdings, the positive impact of rental income growth and its level of inflation protection need to be compared to the inevitable increase in the cost of debt to determine its impact on the net operating income of the real estate investments and ultimately, its future valuation.

6

Given the challenging market environment, how are you positioning your property portfolios for the next 12 months?



The current market environment is indeed challenging, with most countries experiencing a spike in inflation and reacting with high interest rates (Japan is an exception here). Then, the ongoing war in Ukraine set off an energy crisis and further lockdowns in China exacerbated supply chain issues, all of which contribute to increasing the chances of a recession. From a risk management perspective, given this global uncertain economic environment, we recommend broad diversification across regions and countries, with a slight underweight to Continental Europe and slight overweight to the US and APAC, which will see relatively better economic performance.

However, by contrast we think it is sensible to take tactical positions on sector weights. It's important to focus on sectors that are able to raise their rental income to match or even exceed inflation in order to off-set the growing cost of borrowing. This net operating income growth is key to counterbalance the potential valuation falls as discount rates begin to rise. The logistics sector has been able to do this to date with the rise of online retailing and need for modern logistics buildings outstripping supply.

We believe this will continue into 2023 and remain overweight to this sector, but wary of adding more exposure at today's elevated prices. Residential is another sector we are overweight in, as it has seen significant rental increases as buying property is becoming ever more expensive, the supply of rental properties struggle to keep up with demand, and the fact that people need somewhere to live.

Then there are more specialist and emerging property types which are more counter-cyclical, such as labs for life sciences and medical housing, data centers and properties with ESG credentials, such as affordable housing and environmental living and workspaces. In contrast, the retail sector and the traditional office sector are impacted by factors such as the cost of living crisis and the home office trend, so they will remain very underweight.

7

The global living sector is currently attracting clients. What are the drivers of this and where are the investment growth areas?

There are a number of drivers that make investing in the living sector attractive both in the short and long-term. The considerable population growth with inter-regional urban migration is bolstering demand. Also, the significant supply capacity constraints in metropolitan areas, combined with a substantial 20-year rise across many developed markets in the relative cost of residential purchases to leases is driving growth and sector outperformance.

Increases in interest rates and hence mortgage rates make renting more compelling. In addition, the short-term, resettable leases provide inflation protection relative to the rest of the market. Moreover, the fact that people need somewhere to live makes the sector less correlated to typical real asset volatility and seen as defensive in nature.

We see interesting growth opportunities in the sector arising from extensive differences in the maturity of the rental sector itself, particularly across Europe and APAC. While the lion's share is represented by multifamily rental apartments, there are other growth areas such as student housing in locations where the industry is under-developed, senior housing where the aging population provides support for suitable housing and for those with medical needs, affordable housing with its social angle and the single family rental sector, where stretched affordability makes family homes unattainable.

8 Why is ESG important to you and your clients and how do you keep up with ESG trends?

Having an ESG focus on all our investments is our fiduciary duty as investment managers and as human beings living on this planet, and makes good business sense. We know that *green* real estate typically benefits from higher values compared to *brown* assets through lower void lengths, lower obsolescence (regulatory or otherwise), reduced depreciation, lower operating costs, better tenant covenants and improved tenant retention.

Furthermore, as real estate investors, we are especially influential given buildings/construction account for almost 40% of energy and process-related emissions (UNEP). With USD 26 billion of AuM, we are in a highly privileged position of influence, with sway over 100+ general partners and other institutional investors who we sit alongside[1].

ESG education is essential to us, where we share best practices and new trends within our real estate ESG forums, UBS-AM's inhouse Sustainable Investing teams (SI), the Group level Sustainability and Impact organization (GSI) and third party environmental consultants. All these sources feed into our newly launched ESG curriculum, specific to real estate, which is tailor-made in house and has the purpose to make complex ESG concepts easily understandable for our team. In addition, ESG objectives have also been incorporated into every investment and portfolio management team member's annual targets, ensuring they are made accountable.

9 Let's switch from theory to practice: how do you incorporate ESG into your investment process and how do you measure success?

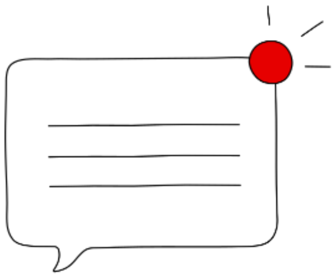
We've embedded in our investment processes various ESG investigation and analysis aspects on all investments. This will include how ESG policies are incorporated into the property and fund strategy, how ESG regulations impact funds, and any sustainability initiatives the fund and its properties are already participating in.

At a property level, we consider environmental management systems, consumption of energy and water, greenhouse gas emissions, physical risk exposure and waste management and associated reduction targets. We also look at design and construct efficiency measures where relevant (ie solar panels, thermal energy heating, rainwater harvesting). Moreover, we identify bespoke health and wellbeing measures (ie cycle facilities, light and air sensors), community engagement programs on the use of communal space and social elements such as diversity, equity and inclusion.

To measure our funds' ESG results we use the Global Real Estate Sustainability Benchmark (GRESB), recognized as one of the leading global sustainability benchmarks for real assets and with significant investor and consultant support covering around USD 6.4 trillion of AuM. GRESB measures the performance of the unlisted property funds against a multitude of ESG metrics and provides a numerical score. Success is measured by having a portfolio of investments that exceed the GRESB benchmark. Where investments fall below the benchmark, they are challenged to improve their scores or risk being sold, and indeed our risk monitoring process and annual hold/sell processes now incorporate a number of ESG factors that influence our decision making.

Additionally, we use a proprietary ESG assessment that we run alongside GRESB and enables us to ask questions additional to GRESB's survey; it also allows us to assess the small portion of non-GRESB participants and compare them to the rest of our GRESB-participating investments. Our portfolio managers are increasingly building their portfolio strategies around ESG attributes of our underlying funds, with embargoes placed on underperformers. This approach will only increase going forward across our platform.

10 Can you tell us about how the way you invest for your clients has evolved?



Our approach to investing for our clients has evolved significantly over the years. Around 15 years ago when we started the business, most investors did not have exposure to global unlisted real estate and the most efficient way to do this was via a portfolio of diversified regional funds and some specialist fund investments. This approach is still valid for some investors accessing global real estate for the first time.

However, now many investors already have some global unlisted real estate exposure, the next step is to make more concentrated investments via specialist funds, co-investments, club deals and programmatic joint ventures (JV). Also, investors are looking for dislocations in the market where portfolios need to be recapitalized or owners of funds or portfolios need to sell quickly at a discount.

This has given rise to the real estate secondaries market which has created two typical transactions: the primary limited partner (LP) sale of a fund investment at a discount and the GP-led secondary, where general partners (GP) as owners of the portfolio are looking to avoid selling their assets (ie a fund life comes to an end), and recapitalizing them with new equity.

The two areas of investment growth for our clients are in co-investments and recapitalizations, where we create new *fund formations* with GPs or operating partners. For co-investments, given we have over USD 26 billion already invested, our investment partners will come to us first if they need capital to execute large transactions they cannot complete themselves. This means we have first choice and unique access to co-investment deals in the market. This allows our investors to execute more concentrated investments, with often lower fees and complementary to their existing holdings.

Our investments for clients involving recapitalizing portfolios and the formation of new funds have been the largest area of growth for us with around USD 7 billion deployed in the last few years[1]. Here we work with the GPs or property operators to change the ownership structure of their portfolio we want to invest in. The source of portfolios that can be recapitalized comes in many forms, from closed-ended funds coming to the end of their life, to businesses wanting to off-load properties held on their balance sheet.

A typical example is a value-add fund having stabilized assets that need to be sold as this fund comes to the end of its life. We buy the assets from the fund, typically at a discounted price given there is pressure for the fund to sell, and then have a choice with the operating partner of those assets on how to structure the ownership. Often we prefer to create new *fund formation* by wrapping these assets into an open-ended fund structure to grow the portfolio and attract like-minded investors.

This allows us to target pre-specified portfolios that we can underwrite and want to get access to, it deploys out clients' money straight away. And as the founder investor, we are able to dictate the terms of the fund – providing low fees for our clients in perpetuity and also creating better liquidity, should we want to exit at some stage.

So whether it is investing via co-investments, recapitalizations and fund formations, secondaries, programmatic JVs, specialist funds and club deals – the way we invest for our clients has significantly evolved such that we are executing bespoke real estate investment solutions for some of the largest and most sophisticated investors in the world.

[1] UBS Asset Management, Real Estate & Private Markets (REPM), data as at 30 June 2022. Equity includes both invested and committed assets.
[2] Real Estate: aim for broad diversification, Panorama, UBS Asset Management, July 2022.

For more information, please contact:

UBS Asset Management
Real Estate & Private Markets (REPM)

Eric Byrne
+44-207-901 52 32
eric.byrne@ubs.com

Follow us on LinkedIn

To visit our research platform, scan me!

www.ubs.com/repm-research