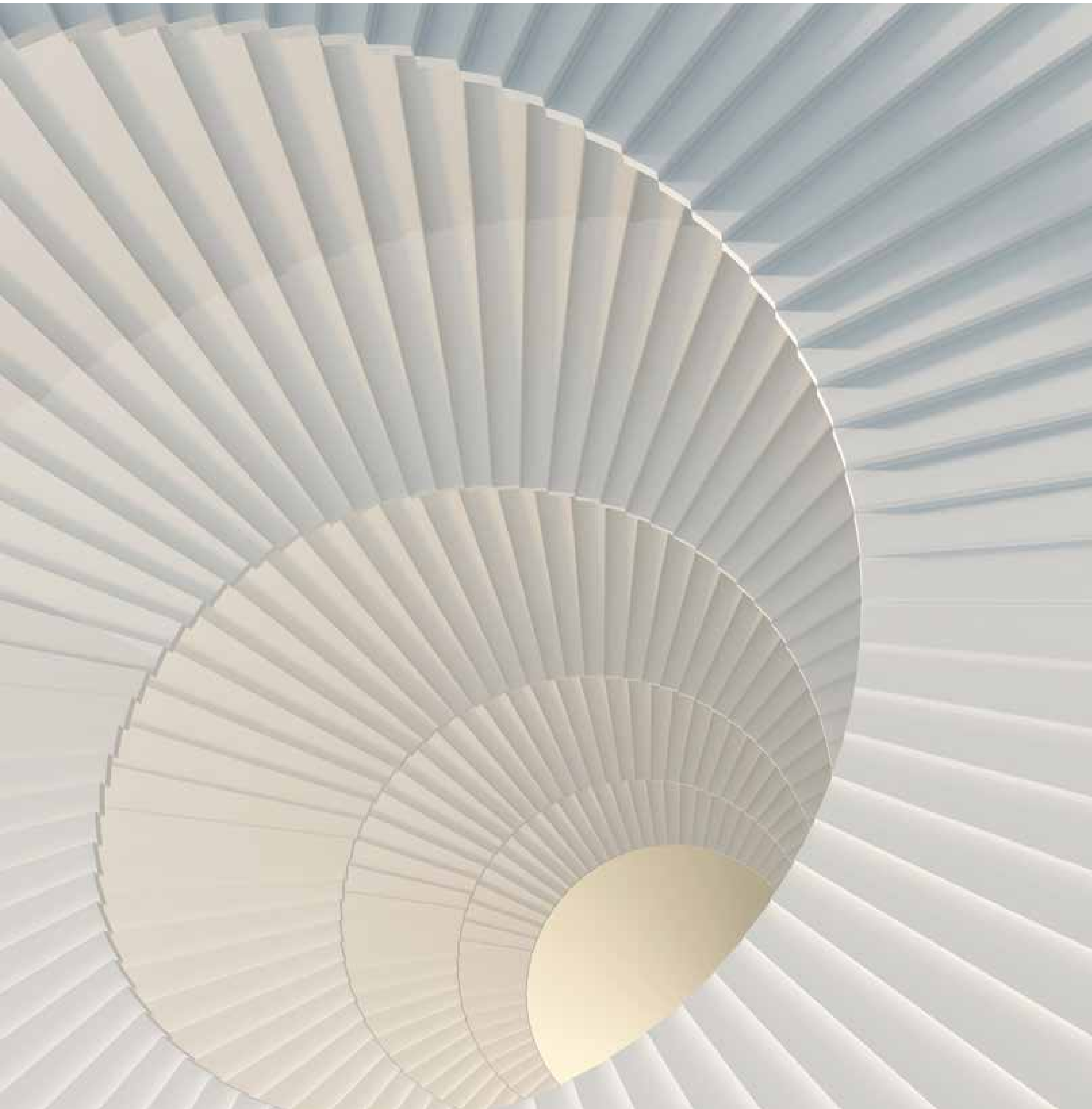
PERE

Europe roundtable



R O U N D T A B L E

SPONSORS
ARES MANAGEMENT CORPORATION • BC PARTNERS • KENNEDY WILSON
MACQUARIE ASSET MANAGEMENT • SIGNA REAL ESTATE

Making decisions in uncertainty

Institutional capital continues to flow into European real estate. But with inflation high and interest rates poised to increase, the pressure is on managers to navigate risk successfully in an unsettled market. Stuart Watson reports

While global capital pours into European private real estate markets, the wider economic and political picture presents some troubling features. CBRE recorded total investment volumes of €359 billion in 2021, up 25 percent on 2020 and 8 percent on 2019, the previous record year. Buyers could point to strong investment performance to justify their enthusiasm. MSCI data shows total all-property returns of 11.6 percent for the first nine months of 2021, outstripping whole-year figures of 3.5 percent in 2020 and 7.7 percent in 2019.

Yet economic and political clouds are gathering. Supply-chain issues continue to impact European economies, and together with spiking gas and oil prices, have contributed to surging inflation. Interest rates are poised to rise, stock markets were spooked in January and the specter of a border conflict between Russia and Ukraine looms over the east of the continent.

The participants in *PERE*'s Europe roundtable discussion are, of course, acutely aware of all these developments. But they also have plenty of investor capital in their pockets that must be deployed, and in the words of Stéphane Theuriau, head of real estate at London-headquartered manager BC Capital, "the challenge for us is to continue to trade in this uncertain environment."

While volatility in the public markets is unsettling for investors, it has benefited the private real estate space, argues John Ruane, co-head of European real estate equity at global alternative investment manager Ares Management Corporation. "The growth trend in the allocations of global investors into alternatives versus the liquid markets is continuing at pace, whether that's into real estate, private credit, private equity or infrastructure. Alternatives are less volatile and, over time, have given a premium return to the public markets."

Spiraling inflation

Inflation is a pressing concern for the participants in their everyday business activities. Consumer prices in the eurozone rose by 5.1 percent in January from a year earlier, while the UK recorded 5.4 percent inflation in December.

"There is a lot of debate among economists about how long inflation will last. A lot of questions have yet to be answered. It remains very unclear how labor shortages, for instance, will impact wages going forward, potentially keeping prices high beyond the short-term. It is therefore difficult to predict what will happen to interest rates," says Christian Goebel, co-head of EMEA real estate at Macquarie Asset Management.

Many investors view rental growth

John Ruane

Partner and co-head, European real estate equity, Ares Management Corporation

Ruane joined global alternative asset manager Ares in 2013. The firm's real estate business manages around $41.2 billion of capital across its equity and debt strategies. Its European real estate team invests in the value-add and opportunistic space, focusing on the industrial and residential sectors.

Richard A Johnson

Head of international capital markets, SIGNA Real Estate

Johnson joined SIGNA in 2020 with a brief to expand the Austrian-headquartered group's connections among international institutions, sovereign wealth funds and private capital. The privately managed development and investment company manages over €20 billion of real estate, principally prime assets in German-speaking cities.

Stéphane Theuriau

Partner and head of real estate, BC Partners

Theuriau heads the real estate business at alternative asset manager BC Partners. The firm announced the final close of its debut real estate fund, BC Partners European Real Estate I in January having secured €900 million for the value-add and opportunistic strategy. Around 40 percent has so far been invested.

Christian Goebel

Co-head EMEA real estate, Macquarie Asset Management

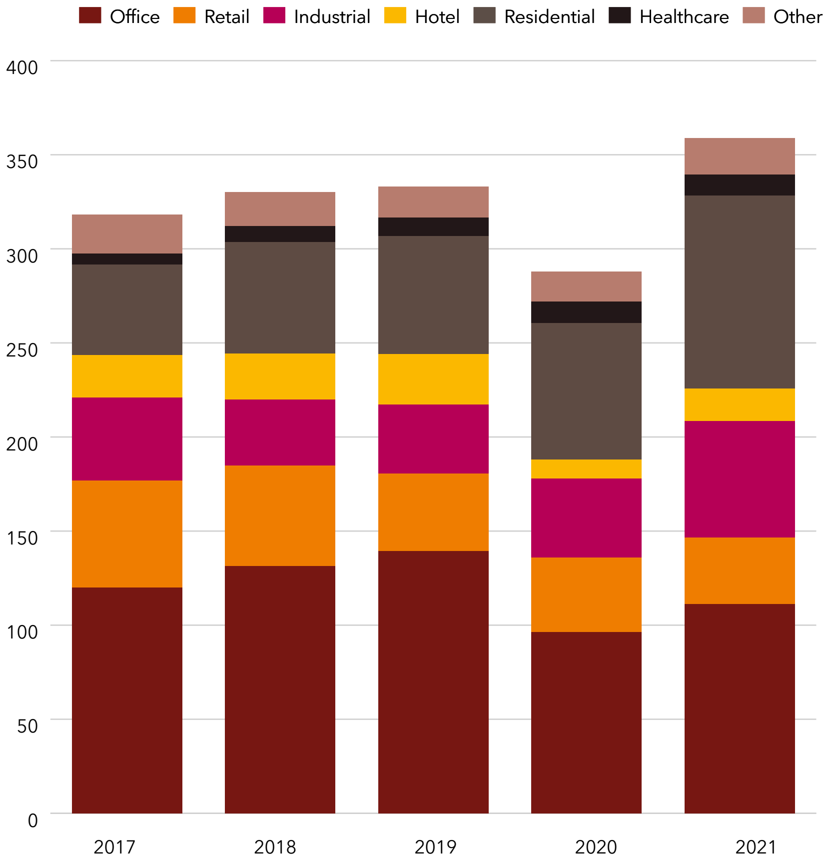
Goebel co-heads the European real estate division of Macquarie Asset Management. He was previously executive vice-president at GLL Real Estate Partners, which was acquired by Macquarie in 2018. MAM's network of 157 real estate professionals manages $12 billion of assets globally.

Fiona D'Silva

Head of investment, Europe, Kennedy Wilson

D'Silva leads Kennedy Wilson's European investment and acquisition efforts. She has 22 years of real estate experience, and has worked at Goldman Sachs and Deutsche Bank. Kennedy Wilson is an owner, developer and operator, managing around $21 billion of real estate assets, half of which are located in Europe.

European investment volume surged in 2021, with industrial and residential showing the biggest gains (€bn)



Source: CBRE Research

> *"A major theme for the office sector is the impending capex requirements to bring office buildings up to the required ESG standards"*
>
> **JOHN RUANE**
> ***Ares Management***

within the real estate sector as a hedge, of sorts, against the current high inflation we are witnessing – especially characteristic of multifamily housing where short-term leases allow rents to rebase more regularly, says Fiona D'Silva, head of investment for Europe at global real estate investment company Kennedy Wilson. This sentiment, along with the lower interest rate environment, has led to a "wall of capital" targeting real estate, which will face a rapidly-developing set of investment challenges.

"We are facing an interesting time when it comes to interest rates," says D'Silva. "Some of the yield compression investors are having to buy into looks fine today. However, if we went back to 4 or 5 percent interest rates, which we may or may not, suddenly those yields start to look tight. And so, how we price exits, how low can we keep our cost of debt, how long we can hedge it for, those are the things that impact my day-to-day. How do we get this right and make no mistakes? Because a lot is changing quite rapidly."

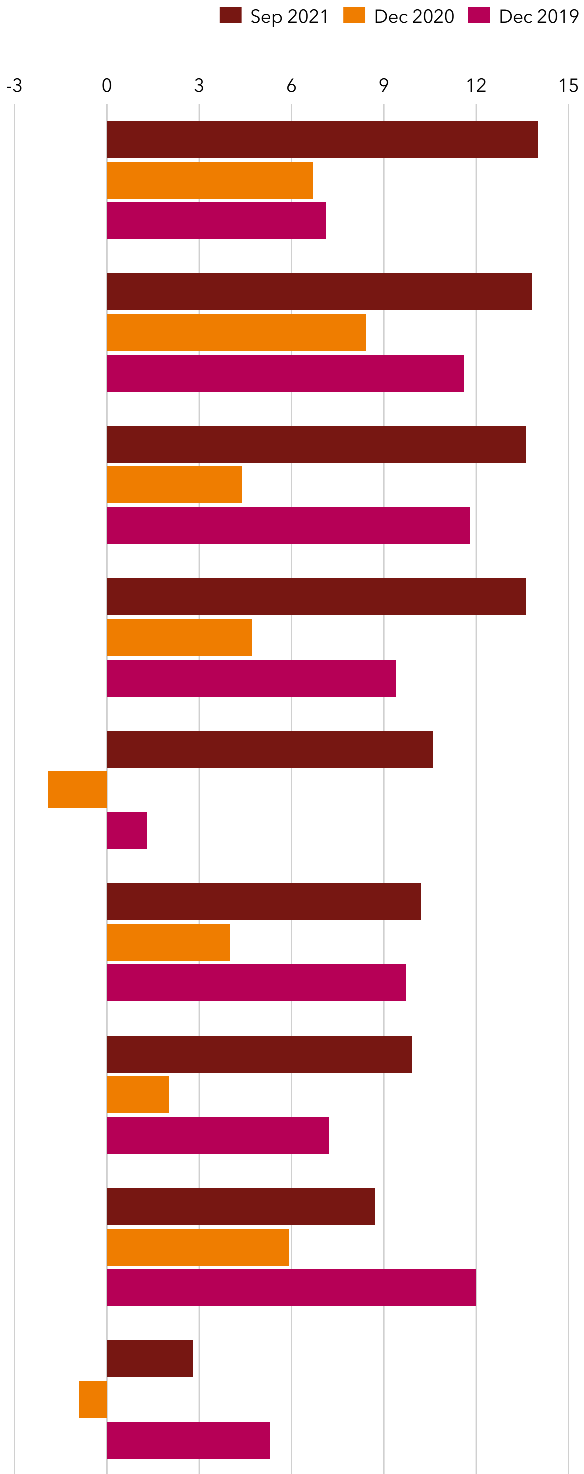
Borrowing on balance sheet to lock in low rates for the long term is one way for managers to capitalize on value growth, she suggests.

"Whether as interest rates rise, we are going to be able to do that for much longer is a question. But it has been very advantageous in the past," says Richard A Johnson, head of international capital markets at Austrian-headquartered property investment and holding company Signa Real Estate.

He too stresses the importance of robust underwriting in the current market environment.

"If you look back over a 30-year period, current bond rates are historically low, but that does not mean that a rise cannot damage you given how low current yields are," he says. "Calling inflation and the underlying bond and financing environment, incorrectly, could significantly damage your

All property total returns to Q3 2021 easily outstrip full year figures for 2019 and 2020, with Germany, Central and Eastern Europe and Nordics among the best performers (%)



Source: MSCI

situation, whether it's on balance sheet or in a fund."

Exceptionally low interest rates have made it difficult to compare today's dynamics with previous cycles and predict the impact of tighter lending conditions on pricing, says Goebel. "However, spreads to government bond yields seem wide enough that there could still be significant scope for interest rates to increase before pricing is impacted."

Managing the next stage

Case numbers alone would suggest that the coronavirus pandemic is raging across Europe with as much intensity as ever. But vaccination is reducing serious illness, and in turn reducing the governments' need to rely on economy-chilling lockdowns. The continent is learning to live with the virus. "Maybe the posture at the moment is not looking at managing the pandemic, but managing the next stage, seeing what business looks like with the pandemic moving behind us and recovery emerges," muses Johnson.

CBRE data demonstrates what every investor knows: beds and sheds have been the in-demand property sectors during the pandemic. In 2021, European logistics volumes grew by 48 percent year-on-year, while multifamily was up 42 percent, coming close to rivalling offices' position as the best-selling segment.

Meanwhile, investors wishing to divest themselves of low-performing retail or office assets have found it difficult to do so. "If you want to rotate out of negative rental growth retail assets, it is too late, and a lot of listed companies have tried to exit bad office assets and then pulled them from the market because they weren't getting the prices that they wanted," notes Theuriau.

"We are looking at lifestyle and technological changes that are going to be there for the next 30 years. We also see cost inflation at the point of entry, rising capex budgets, and cap rate

European deals of the year

The participants select the smartest and most striking transactions of 2021

Stéphane Theuriau: In June, Blackstone's £1.25 billion ($1.75 billion; €1.53 billion) take-private of UK logistics and housing developer, St Modwen. "That is about going upstream – buying the tool that you need to create assets. The liquidity at the back-end is less easy, but in this low interest rate environment if managers want to make outsized returns, they have to take operational risk, or try to find some operational leverage somewhere."

John Ruane: In July, AXA IM Alts, the alternative investments arm of AXA Group, raised €1.9 billion of equity for a life sciences strategy, on the back of its €500 million acquisition of life sciences platform Kadans Science Partner in November 2020. "There are a lot of examples of platform creation and large-scale recapitalizations at the moment. In this case AXA bought a great platform, turned it into a fund and then scaled capital around it to grow it."

Deutsche Wohnen: €22 billion takeover by Vonovia demonstrates the scale of demand from investors to diversify and pursue apartments and logistics opportunities

Christian Goebel: In October, listed German residential real estate company Vonovia completed the €22 billion takeover of rival Deutsche Wohnen. "One of the largest European real estate transactions to date, it demonstrates the sheer scale of demand from institutional investors to diversify and pursue apartments and logistics opportunities. With so much capital available, you need to be extremely disciplined right now to do smart deals in those asset classes."

Fiona D'Silva: In December, UK industrial REIT, SEGRO, bought a portfolio of offices on the Bath Road, Slough, from AEW for £425 million ($575 million; €503 million). SEGRO had previously sold the same assets to AEW in 2015. "People are looking at change of use strategies for offices in locations where they may not have the highest and best use. This transaction is quite telling of the changes we're seeing in the evolution of the asset class where a change of planning will see offices turn into data centers, film studios, life sciences and other industrial use assets."

Richard A Johnson: In December, developer Seaforth Land is reported to have let the office space at its 35,566-square-foot mixed-use refurbishment project at Bleeding Heart Yard, London, to Swiss Bank Julius Baer for its new UK headquarters. "It's a small-scale example of the kind of clever reuse of an existing urban and complicated environment that will be needed if we're going to revitalize cities after the pandemic."

compression that is mostly behind us, and our job is to invest in this risky uncertain environment. And we only do this by thinking, 'Am I investing in a place where I can see rental growth?' Because of those lifestyle changes that is probably going to come from a combination of location and product."

A successful strategic approach will not be as simple as picking winners from among asset classes, says Ruane. "Within each asset class, where will the outperformance be and where will the underperformance be? For example, industrial and logistics has seen a lot of cap rate compression and a lot of rental growth. We continue to believe the macro trends will support growth in industrial. On the flip side, retail was defined as a loser, but there are absolutely investable parts of that market, with sustainable tenant and consumer demand. That evolution in real estate will be different to what we have seen over the past two years, which was big-bucket sector plays."

War for talent

Office remains the most invested asset class, and the sector's post-pandemic future is inevitably a hot topic in the discussion. There is a consensus that the shift to flexible working will create

> *"Cap rate compression is mostly behind us, and our job is to invest in this risky uncertain environment"*
>
> **STÉPHANE THEURIAU**
> **BC Partners**

> *"The key to success is to provide occupiers with the ammunition that they need in order to win the 'war for talent'"*
>
> **CHRISTIAN GOEBEL**
> **Macquarie Asset Management**

> *"Calling inflation, and the underlying bond and financing environment incorrectly, could significantly damage your situation"*
>
> **RICHARD A JOHNSON**
> **SIGNA**

winners and losers among office assets. Successful locations will be located within environments to which workers are happy to return, says D'Silva. "That is all about light, green spaces, and amenities. It is incredible the response we have got from tenants and prospective tenants about having employees go back to work post-pandemic to a location where health and safety is easier to manage."

"The key to success is to provide occupiers with the ammunition that they need in order to win the 'war for talent,'" says Goebel. "Companies are now reimagining office design, refocusing on factors like occupancy ratios and health and safety. As investors, we have to explore what we can offer potential tenants to help them attract and retain that talent. Today, we're no longer just talking about ESG, we are talking about post-pandemic architecture, and numerous other criteria that office buildings of the future will have to fulfill."

Ruane agrees that improving office buildings' ESG credentials will play a crucial role in enhancing their appeal to occupiers and therefore to investors. However, the costs involved present a conundrum for the real estate industry. "A major theme for the office sector is the impending capex requirements to bring office buildings up to the required ESG standards. That does not fit well if you're an investor holding a portfolio of office buildings for yield, then you layer the impact of post-covid work from home.

"Employees are going to be pickier as to the offices they want to go back to. That plays to building new offices because you can deliver the quality of asset that is relevant to tenants, to their employees, and importantly to the end investor. And then it will also play to those managers who can reposition older assets. But I think there's still going to be a subset of the market that will no longer be relevant and will need real consideration about alternative use."

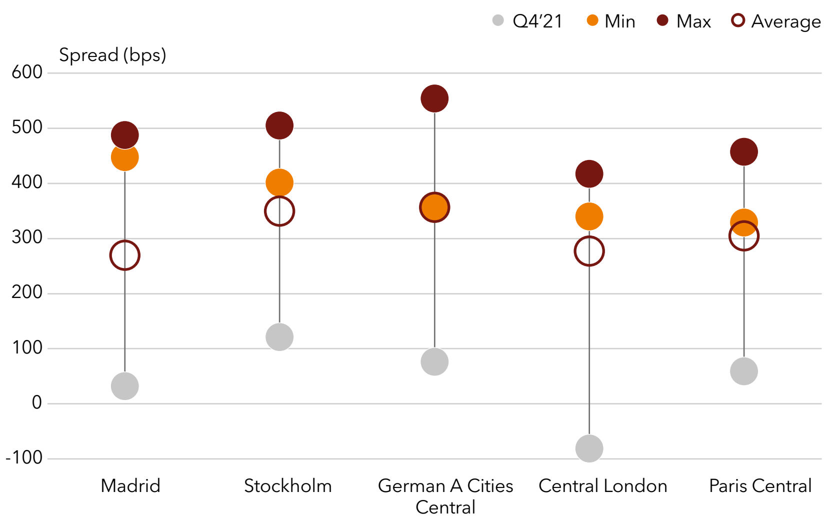
Johnson argues that while the "default setting" will be to build new and greener offices, the approach potentially has an important drawback. "One solution will not fit all. The challenge for all of us is that in some cases there is a risk of releasing more carbon by building new than by refurbishing, so even within the general move toward efficient ESG-compliant buildings, that calculation needs to be understood."

The irresistible drive to higher standards means managers must attempt to account for the future ESG requirements of both tenants and investors. They must do this while navigating increasingly stringent energy performance regulation and at the same time working out how to price the necessary capex into their underwriting, says D'Silva. "ESG will become a more important factor in determining value, but the methodology for doing that is still emerging, and the sector runs the risk of manipulation and greenwashing," she says.

"There is still some need for consistency across the benchmarks and interpretation of results across different managers. There are improvements that can be made to every asset, and

> *"It is unlikely that a single global benchmark will evolve for everyone to peg their ESG results to in the short-term"*
>
> **FIONA D'SILVA**
> **Kennedy Wilson**

The gap between property yields and 10-year government bonds means there is still room to maneuver if interest rates rise



Source: RCA Hedonic Series office yields; min-max range since 2007

Diversity, equity and inclusion move up the agenda

The 'Great Resignation' could be catalyst for swifter change

Fiona D'Silva: At Kennedy Wilson, we have made conscious efforts on diversity. Across our European operations, women make up 47 percent of the company and half of the business heads. There are now some other firms pursuing specific diversity targets. The real estate sector still has a long way to go, but the awareness is here. Investors are more focused on it, and usually that's a good catalyst for driving change.

Christian Goebel: We are seeing in the 'Great Resignation' that employees are choosing companies that are more aligned to their values and provide a better experience. This is likely to reward firms that have already authentically prioritized DE&I, as well as giving back to the community. I am very proud to work with such a diverse range of people and think that our focus on sustainability is also a compelling reason to join.

Stéphane Theuriau: The most effective method to increase diversity quickly is probably through hiring. We said our last three hires had to be female. We realized that without taking that approach, we would not get to where we wanted to be.

John Ruane: One way to immediately make an impact is through internship programs and analyst and associate hiring – making those areas more accessible for minorities. People sometimes perceive that if there are not people who look like them in an organization then they will not be able to break into it. We have to start breaking down those barriers from the bottom up.

Richard A Johnson: Organizations that perhaps secretly wondered whether DE&I could be successful have been positively surprised, both in terms of increased employee motivation, and by improvements to the cultural feel of an organization. A more diverse organization performs better, feels like a nicer place to work and retains staff better.

you have to work out what that will cost, and how long you can amortize that over. It is unlikely that a single global benchmark will evolve for everyone to peg their ESG results to in the short-term."

A different lifestyle

During the discussion, participants also considered the changing role of cities. Theuriau put forward a theory that employees may be increasingly reluctant to commute long distances to districts that feature concentrations of office towers offering large quantities of commoditized office space, such as Canary Wharf in London and La Défense in Paris.

"We may be at the beginning of some sort of decentralized way of managing companies – effectively having offices closer to where people want to live. This is because of technology, the price of housing in the large cities, and the aspiration for a different lifestyle, which has been accelerated by covid. That could be a worry for owners of super-large assets which were supposed to serve as headquarters."

Those locations are well-placed to adapt, however, argues Ruane. "While they may have certain challenges, they will also continue to reinvent themselves because they have critical mass. Canary Wharf is predominantly under a single ownership and has good public transport. It will evolve and still offer high quality space at a discount to other locations."

Johnson believes that in future, the real estate industry will have a greater role to play in dealing with the social consequences of urban transformation. "By not choosing to, or it being made very difficult to redevelop or refurbish a certain sort of obsolete building, we would be leaving 'empty teeth' in city centers. Where it makes sense, we should preserve and improve to maintain and invigorate the urban core.

"The ESG considerations that we are all struggling to incorporate and deal with are not just being driven by our capital providers, or the banks, or governments; they are also being driven by the industry itself trying to find a way to deal with some of the societal parts of this jigsaw," Johnson adds.

"We are not going to find complete solutions in the next five to 10 years, but I think the fact that we are all moving actively in this direction shows just how far the industry has developed."

European private real estate is not immune to the volatility of the continent's economic and political environment.

However, it does offer institutional investors more shelter from the turbulence than some other asset classes, and therefore capital will continue to flow into the sector.

But for managers, the task of deploying that money is only set to become more complex. ■

Experienced Leadership. Investment Discipline. Dependable Partner.

The Ares Management Real Estate Group manages comprehensive public and private, equity and debt strategies.

We maintain a time-tested and consistent approach across our equity and debt strategies focusing on major property types that we believe have value creation opportunities, located in liquid markets with diversified economies.

Ares Management's global platform has approximately $306 billion of assets under management with approximately 2,100 employees operating across North America, Europe, Asia Pacific and the Middle East*

For more information, please visit aresmgmt.com

ARES

* As of December 31, 2021. AUM amounts include funds managed by Ivy Hill Asset Management, L.P., a wholly owned portfolio company of Ares Capital Corporation and registered investment adviser. All investments involve risk, including possible loss of principal; no guarantee is made that investments will be profitable. This material is for informational purposes only, and does not constitute investment advice or an offer to buy or sell any security, financial instrument or service.

REF: AM-01450