# LOW INTEREST HIGH DEMAND

With interest rates at record lows, investors have been increasing allocations to real estate across all regions. We profile the strategies, key markets and structural opportunities

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"DURING TIMES OF UNCERTAINTY, PROPERTY HAS ALWAYS BEEN SEEN AS A SAFE HAVEN"

Left: La Défense, Paris

The year 2020 will be most likely remembered as a tipping point in many ways. The world has experienced a synchronised shock and will come out of it traumatised, but also wiser, stronger and more prepared.

During times of uncertainty, property has always been seen as a safe haven. Despite the complexity of the economic and political landscape and the short-medium and long-term implications of the pandemic, which are yet to be identified, there is still value to be found in the markets.

Interest rates are at record lows, and have been for a long time. That already makes real estate attractive.

Then there's property's long-term appeal. Developed countries face increasing levels of retired people, and real estate offers a good annuity match.

Of course, economic, political and cyclical risks always exist. So, what is interesting to look at is how investors are working around these through pricing and diversification. An investor's domestic outlook is often a driver. Asian institutional investors, for example, such as sovereign wealth funds, pension funds and insurance companies, need to diversify globally, as their rising allocations to real estate cannot be absorbed locally.

On the ground, different strategies help investors find the risk/return values they need from the market. Core investors value transparency and liquidity, with demand and supply fundamentals of paramount importance to reduce risk. In 2020, 'flight to quality' will prevail. This means that prime offices and logistics in key global markets, such as New York, Paris, Los Angeles, German cities, Tokyo and Sydney will remain in demand. In 2019, New York, Los Angeles, San Francisco, Paris and London were the most active markets, according to Real Capital Analytics. Domestic investors, who know their local markets well, might also consider prime opportunities in secondary cities, especially with good quality tenants and long lease terms in place.

However, core investors also seek resilient, innovative cities that attract talent and will be more defensive to long-term risks. These include mature cities such as New York, Tokyo, London, Singapore and Los Angeles, smaller cities, such as Stockholm and Barcelona, and also developing ones such as Shanghai, Beijing and Shenzhen. In 2019, Seattle, Beijing and Munich showed the highest year-on-year increase in activity at 59%, 56% and 54% respectively (see chart on page 27).

Other investors feel comfortable riding the economic cycles with value-add strategies. These include developing and emerging markets with better rental growth prospects – logistics, in particular – in the Netherlands, Central and Eastern Europe or Vietnam. According to MSCI, the average net operating income yield for industrial property globally in 2019 was 4.6% compared to 4.1% for offices.

Some investors favour structural opportunities: retirement homes for ageing populations, multifamily in cities with high urbanisation rates. Underscoring this is a more operational approach with active asset management to create value through redevelopment and refurbishment in this low-growth environment.

## TACTICAL BUYING OF RETAIL

Finally, there is a role for opportunistic strategies to capitalise on structural disruption, such as we see in retail. As the sector reconfigures to accommodate an omnichannel approach and additional uses, tactical buying of retail in markets such as the UK and the USA will give investors potential for higher returns. There will be good schemes where rents have already rebased, or where buying cheap provides the flexibility to rebase them.

Looking ahead, there will also be opportunities for re-purposing by adding new uses and creating relevant and attractive mixed-use environments.

In the long term, investors may be challenged by changing occupational requirements towards flexibility, which will lead to shorter leases, just as the world's pension funds need more long income. To mitigate this, investors need to become operational.

There are also pending regulatory risks, especially in multifamily, where rent controls are being phased in to protect tenants in cities such as Berlin and New York. This could lead to limited prospects for high rental growth.

One of the greatest changes in investment will be what's required to tackle climate risks. Meeting carbon-neutral targets and regulatory interventions could negatively affect capital expenditure and operating income for investors. Extreme climate conditions could also affect long- term asset value (see pages 14 and 20).

At a broader level, the environmental, social and governance (ESG) movement, driven by younger generations, is now essential in corporate and institutional investment strategies, health and safety and sustainability do offer a downside protection and should lead to improved risk-adjusted returns as it considers long-term risks.

There is a debate about the shape of the economic recovery in 2021 and beyond. However, with low interest rates, real estate will remain attractive. A mismatch between the availability of 'dry powder' and the supply of good quality stock will keep competition high and yields low. During this phase of uncertainty, rental growth prospects are also limited and some sectors will suffer as long as the downturn lasts, while others will recover faster.

Investors will need to continue to adapt to uncertainty and risk. Careful asset selection, diversification and the right pricing of long-term risk will characterise those which are successful.

With opportunities emerging from structural changes, it is about meeting the need for new products and repricing those that are not fit for purpose. The route to high returns in this part of the market is repositioning, redevelopment and active asset management. ›

"WE EXPECT THE STRONG FLOWS FROM SOUTH KOREA INTO EUROPE TO CONTINUE"



# GLOBAL INVESTMENT STRATEGIES

**Alex Jeffrey, Global Chief Executive, Savills Investment Management**

Investors have been increasing allocations to real estate across all regions, both structurally, as they see that real estate plays a key role in diversifying a multi-asset portfolio, but also because the fixed income market is generating very low returns.

This is a particular driver for investors with lower domestic yields. In Japan, where government bond yields are typically negative, there is strong motivation for investors to look overseas.

We have also seen US investors looking at Europe and Asia-Pacific, and they tend to view further up the risk spectrum than regional counterparts. Some are looking at core funds, but they are in the minority.

At the same time, more Europeans have been heading to Asia, attracted by exposure to the structural growth characteristics and the region's demographics.

Having said this, the synchronised economic shock from the Covid-19 pandemic has churned the real estate markets and is likely to have short-term implications for real estate strategies and capital flows. The investment market saw a meaningful fall off in transaction volumes globally since the beginning of March. This is due to weaker activity on both the supply side, measured by deals coming to the market, and the demand side, measured by confidentiality agreements signed.

Until the spread of Covid-19 is contained and restrictions on movements are relaxed, investment activity in global real estate is likely to remain very subdued. Domestic capital flows are likely to benefit first from the easing of restrictions.

The large falls in equity markets may see allocations to real estate exceed specified thresholds, thereby constraining further capital deployment. Although forced sales have so far been limited, investors tend to divest abroad first and return their focus to their domestic markets.

Of course, real estate markets will be dictated by the size and the duration of economic disruption, which itself will also be influenced by the quantum of defaults (both tenant and banking covenants) and the impact on employment. Short-term concerns about the global economy may also affect capital raising activities.

## ROADMAP TO RECOVERY

Risk aversion is likely to drive some short-term tightening in the credit market, which highlights the importance of secure income streams and reducing exposure to over-leveraged strategies. An analysis of global office markets by RCA indicates that, on average, markets with higher average liquidity tended to be the first to recover their pre-crisis pricing. To investors in these markets, this should provide some comfort and also justify the potentially higher prices paid for assets in the most liquid markets.

Despite this, real estate has not lost its attraction compared with other asset classes. Volatility in equity markets has increased due to the global turmoil and bond yields seem set to remain lower for even longer in the context of lowered policy rates and resumed quantitative easing (QE) programmes by the major central banks globally.

While there will be some near-term challenges in deploying capital, there is, nonetheless, a huge amount of dry powder. According to INREV, the amount of capital raised last year for new investments into real estate reached more than €200 billion, the highest level on record, of which 39% was not deployed at the end of 2019.

The risk-off sentiment and tighter credit environment also presents other opportunities, such as for alternative lenders or debt funds given the lack of such products in Asia at the moment.

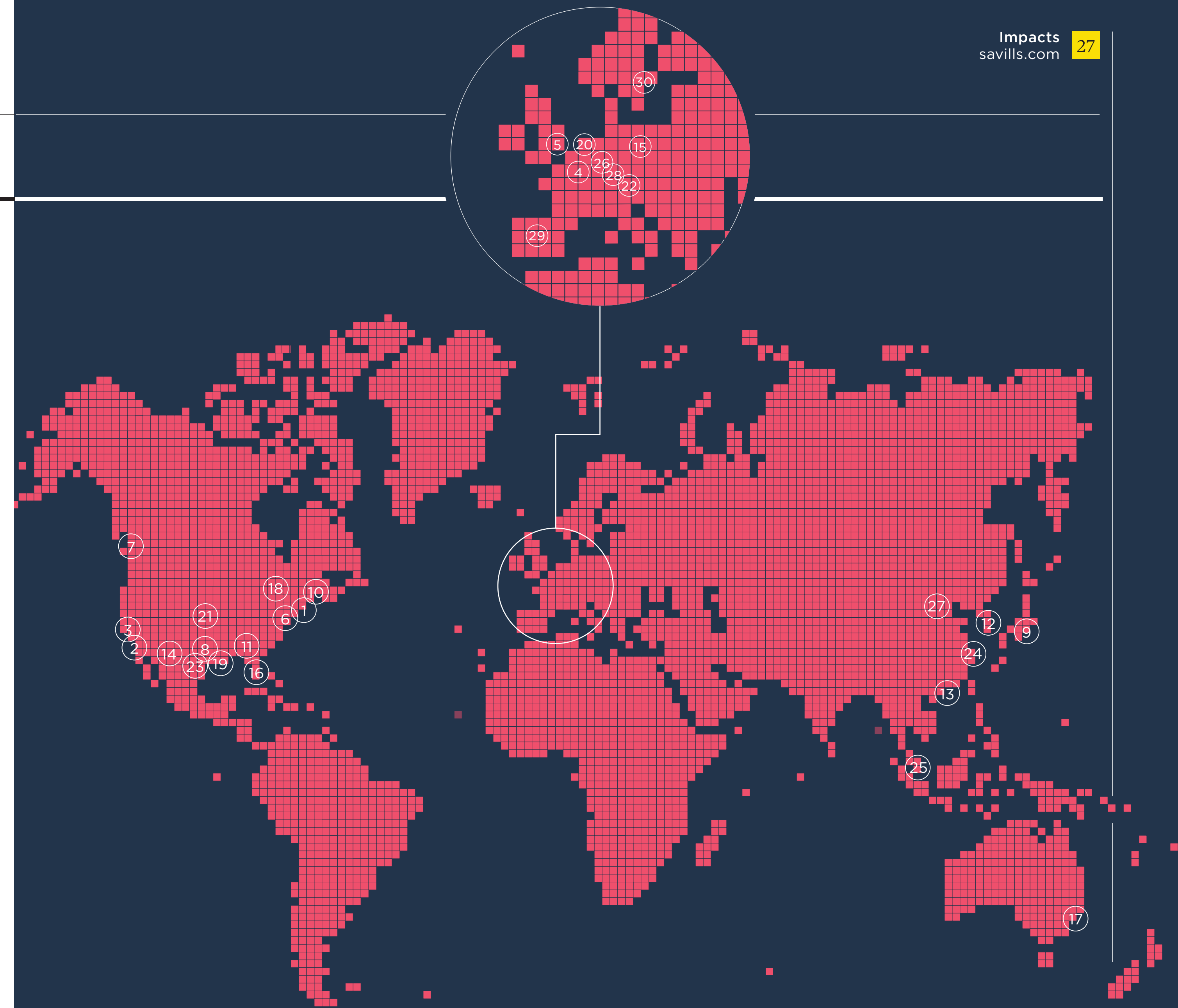
As economies and real estate markets begin to return to some degree of stability, we expect the strong flows from South Korea into Europe to continue. The size of their savings pools are large and growing quickly, and have outgrown the ability of their domestic real estate market to absorb them. It is key for them to look overseas.

There will likely to be significant competition for good assets at that point. Investors are increasingly relying on third parties with a strong local presence to help them access deals. They are also controlling risk by diversification through region and sub-region, by having good teams on the ground to help them invest and manage the assets, and by a judicious approach to leverage. In the past, cycles have been exacerbated by the magnetic effect that real estate seems to have towards leverage. These days, investors are more conservative in approach.

## ALTERNATIVE APPROACH

With real estate moving towards more operational business models, levels of international experience are also dictating what risk investors are taking in newer alternative sectors, such as private rented residential and student housing.

Investors who have not invested in European real estate before, for example, will still take a more traditional approach to building up an exposure to the established sectors first. Those who have a substantial invested portfolio overseas will be looking to counter the lower yields for office and logistics by investing in alternative sectors that could potentially achieve higher yields. Many of these newer sectors are driven by structural factors other than the cyclical health of the economy. ■



## MOST ACTIVE METRO AREAS

*Volume of investment ($) in 2019*

Key: ■ Investment volume ■ Year-on-year change

| Metro area | Investment volume | Year-on-year change |
|---|---|---|
| 1. New York | $47 billion | -22.2% |
| 2. Los Angeles | $39 billion | 1.5% |
| 3. San Francisco | $35 billion | 23.3% |
| 4. Paris | $31 billion | 4.7% |
| 5. London | $26 billion | -28.0% |
| 6. Washington | $23 billion | -0.5% |
| 7. Seattle | $23 billion | 59% |
| 8. Dallas | $22 billion | 2.9% |
| 9. Tokyo | $20 billion | -2.7% |
| 10. Boston | $18 billion | 33.5% |
| 11. Atlanta | $17 billion | 1.3% |
| 12. Seoul | $16 billion | -5.1% |
| 13. Hong Kong | $15 billion | -42.2% |
| 14. Phoenix | $15 billion | 10.7% |
| 15. Berlin | $15 billion | 22.5% |
| 16. Miami | $14 billion | 13.9% |
| 17. Sydney | $14 billion | 1.6% |
| 18. Chicago | $14 billion | -33.5% |
| 19. Houston | $14 billion | -14.8% |
| 20. Amsterdam | $13 billion | -14.0% |
| 21. Denver | $11 billion | 0.8% |
| 22. Munich | $11 billion | 53.6% |
| 23. Austin | $10 billion | 38.5% |
| 24. Shanghai | $10 billion | -14.4% |
| 25. Singapore | $10 billion | 26.4% |
| 26. Ruhr | $10 billion | -22.4% |
| 27. Beijing | $10 billion | 55.9% |
| 28. Frankfurt | $10 billion | -27.2% |
| 29. Madrid | $9 billion | -2.0% |
| 30. Stockholm | $8 billion | 52.5% |

**Source** Savills Research using RCA