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Europe
Roundtable
2020

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Finding opportunities in times of scarcity

*Participants in PERE's Europe roundtable consider the best method to deploy capital in an expensive and undersupplied market. By **Stuart Watson***

It is not the most optimistic start to the year in Europe: economic growth in the Eurozone almost petered out in the last quarter of 2019, dwindling to 0.1 percent according to EU statistics agency Eurostat. Meanwhile, Brexit threatens to cast a long shadow over the region as potentially fractious trade negotiations get underway between the European Union and the freshly-departed UK.

The continent's real estate investment market remains largely unaffected by the uncertain political and economic climate, however. Real Capital Analytics recorded €307.7 billion transacted during 2019, a decrease of only 2 percent on 2018 levels, following a particularly active final quarter's trading. In Germany alone, €30 billion of property changed hands in the last three months of the year, representing the strongest quarter of dealmaking on record for any European country.

At the end of January, the five participants in PERE's 2020 Europe roundtable discussion gathered at Nuveen Real Estate's offices in London to discuss how investors and managers are adapting their strategies for deployment in an ever more competi-

tive market. The panel consisted of four managers: Nishant Bakaya, chief investment officer at CA Ventures; Jason Oram, a partner at Europa Capital; Kiran Patel, chief investment officer and deputy global chief executive officer at Savills Investment Management; and David Pearce, fund manager at Nuveen Real Estate; as well as Edward Tran, a partner at international law firm Katten.

Balancing risk and return

Industry veteran Patel kicks off the debate by voicing the key dilemma facing investors in Europe. "Prices have become more expensive and stock is rarer, while capital is constantly there. The big question is how does capital adjust so that it can be active in the market? I don't think anyone can dispute that we are top-cycle. Pricing is very keen, but you can still invest provided you moderate your return expectations. If you want to remain active and still achieve your target return, the only option is to go up the risk curve."

For managers of all types, this is a challenging environment in which to drive returns, he adds. "Real estate is becoming

more management-intensive as leases get shorter and occupiers require more flexibility in a fast-changing business environment. That requires more management activity, and meanwhile regulation is constantly increasing. Cap rates were 6 to 8 percent 15 years ago, a very different ball game to today's 3 to 4 percent, and in a low-return environment, basis points added to cost can really impact returns."

How investors are adjusting their view on the optimum risk-return balance varies by investor, suggests Europa Capital's Oram. "We are seeing a proliferation of core funds in Europe, and debt funds are also growing in popularity. A reason why those formats are popular with investors is because some of them are reallocating capital from other parts of their investment portfolios, often fixed income, to real estate. Meanwhile, because overall returns are down across their wider portfolios, we are also seeing more appetite for value-add strategies. Real estate in general is the winner and it is not isolated to a single aspect of the product offer."

Pearce says Nuveen Real Estate has been beefing up its offering of enhanced-return strategies to respond to investor demand

PHOTOGRAPHY: MICHA THEINER



Nishant Bakaya

Chief investment officer, CA Ventures

Bakaya leads the investment management team at CA Ventures, a vertically-integrated owner-operator with about \$13 billion of real estate under management. The firm expanded into Europe three years ago and is currently undertaking around £300 million of development in the region, largely in the UK student accommodation sector.

David Pearce

Fund manager, Nuveen Real Estate

Pearce is responsible for overseeing all investment, development and asset management activities for the European value-add strategy of Nuveen Real Estate. Part of Nuveen, the investment management arm of TIAA, Nuveen Real Estate is one of the largest global real estate managers with around \$130 billion of assets overall.

Edward Tran

Partner, Katten

Tran advises institutional investors, sponsors, asset managers and general partners on corporate and transactional matters involving direct and indirect investments in real estate and other asset classes. He regularly acts on acquisitions, dispositions, joint ventures, fund investments, co-investments and other investment transactions, many of which are cross-border.

Kiran Patel

Global chief investment officer and deputy global chief executive officer, Savills Investment Management

Patel, who has over 30 years of experience in real estate, joined Savills IM in 2012. The firm manages open and closed-ended funds across Europe and Asia, as well as separate accounts and strategic partnerships, with around €20 billion of assets under management in total.

Jason Oram

Partner, Europa Capital

Oram is a partner and member of the investment committee at Europa Capital, and fund manager of the firm's Pan-European fund series. Europa Capital is best-known as a value-add investor, but has also raised funds in the debt space and is expanding its core and core-plus business. The company is based in London, and has also established offices in Luxembourg, Munich and Paris.



“Availability of capital is not an issue. It is finding the good deals that is the problem”

EDWARD TRAN
Katten

for the value-add segment. “The insurance companies and pension funds we are speaking to want an enhanced return, particularly in Europe. They want their capital to work a bit harder.” Like Oram, he has observed a strong appetite for core and debt vehicles. “We need to be able to offer all those strategies so that global investors can spread their allocations across the different segments.”

Tran observes that in some cases his investor clients are willing to take on more risk. “It is really tough to get good value in the major markets like London, Paris and Frankfurt, so we have seen investors look a bit further afield. I will not quite say Greece and Italy are back on the table yet for many core and core-plus investors, but there is interest in locations further east in Europe like Poland. There is also a search for well-valued opportunities in the less popular cities.”

Yield-focused investors that cannot lower their return expectations may have to move toward more peripheral markets to find yield, Oram concurs. However, “if you are a trader it is all about having confidence in the arbitrage between the yield on cost

that you are creating and the yield that you can sell the stabilized asset for,” he says. “That arbitrage is there because of the supply-demand dynamics.”

While standing investments are in short supply in established real estate sectors, the dearth is even more pronounced in emerging asset classes. In the US, CA Ventures has been active in sectors including student accommodation, multifamily apartments and senior housing. “In Europe, despite clear institutional demand, those segments are characterized by a scarcity of modern, purpose-built property,” says Bakaya. “By default, you have to develop.”

Taking development risk has the potential to enhance returns, but managers wishing to do so may find it difficult to secure development finance, he adds. “For us that is one of the most significant impediments to growing in Europe. Lending on stabilized or income-producing assets is extremely cheap and you can get a significant amount of leverage. But for development in the UK, for example, it is very hard to source construction financing north of 50 to 55 percent

loan-to-value.” For debt funds, however, such scarcity offers an upside, Bakaya says: “Lending in that 55 to 85 percent of completion value range, you can make highly attractive risk-adjusted returns.”

Opportunities through disruption

As the discussion turns to opportunities for deployment, the participants consider how real estate investors can capitalize on the digital disruption reshaping the asset class. “In the new economy where business models are built for five years, not for 50, the perceived safety of some real estate investments is now coming into question. We have seen Amazon disintermediate some of the bricks-and-mortar retailers, and it is likely a long slide down for those assets,” says Bakaya.

He argues that investors are recognizing that their portfolios need to diversify into segments benefiting from growth drivers, in particular “rent-to-consumer” sectors including private rented housing, senior housing and student accommodation. “Those asset classes have not had the level of adoption that you would expect in Europe. In the US there was close to 280,000 units of multi-family delivered last year, while the total UK stock is less than 50,000 units. The market is so under-penetrated that there is at least a 20-year runway.”

Physical retail in the UK has been hammered in recent years, with a string of high-profile retailers retrenching or going bust, and that trend is expected to spread to continental Europe as the uptake of e-commerce increases.

Pearce suggests that the disruption of bricks-and-mortar retail also creates opportunities, however. “Investors don’t want retail right now and some retail that is being repriced will never return to past levels, but there are also mispricing opportunities. We prefer food-anchored convenience shopping and the retail warehouse space, which offers edge of city locations with underdeveloped sites where you can do space optimization, sector amalgamation and mixed-use,” he says.

The European office market is also evolving, with landlords being drawn into

Data capture

The speakers weigh in on the growing utilization of data in real estate investment

Tran: Commercial landlords are using data much more to manage their buildings. They are harvesting information on what tenants are doing and when they are doing it, covering everything from whether the new gym offering is successful to how they manage power and HVAC. Those changes are part of the overarching trends toward greater amenities in office buildings and a more customer-focused management style.

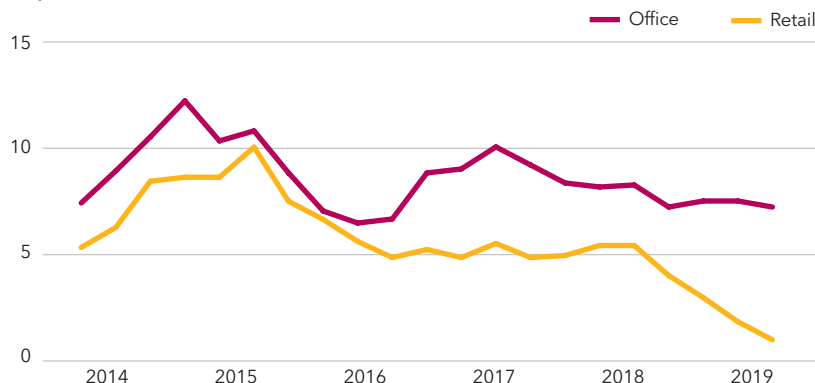
Patel: I have seen examples of linking data to sustainability, such as an app for sharing car parking in a multi-tenant building, so if you are not coming in that day you can make your space available to someone else.

Pearce: We now have a dedicated data team that works in conjunction with our research team. They are scraping various sources of data for European cities and giving each 500-square-meter area a score for factors like proximity to retail, transport and universities. Then they feed real estate factors like supply into the model, and layer over pricing information so you can see where two areas have a similar score but one is cheaper, offering a potential mispricing opportunity.

Oram: For residential buildings, understanding the demographic you are appealing to is vital. For example, 85 percent of the visitors viewing one of our PRS buildings were aged between 27 and 37, so we discovered we were dealing with a very narrow demographic. The building is now over 90 percent let and none of the tenants have children, but 40 percent have dogs, so we need to consider a dog-washing provision. We might not be the long-term holder of that property, but to keep it fully occupied the landlord will need a clear understanding of who the tenants are.

Bakaya: Technology is a critical factor for leasing and marketing in direct-to-consumer sectors. Students like signing leases online, and virtual tours and social media management are extremely important. There is a Yelp.com review for everything in the residential space and if you are not managing consumer feedback, you are dead. In sectors like PRS and student accommodation, participants must share information better, because to enable these sectors to grow we need better operators making better-informed investment decisions.

European real estate returns have dwindled since mid-2018 (%)



Source: MSCI

the flexible, experience-led territory pioneered by serviced workspace operators like WeWork. “There has been a trend away from occupiers talking about cost to looking at attracting and retaining staff. To do that they want the right brand of building, perhaps in a slightly edgier location with a strong amenity offer,” says Pearce.

Oram adds: “In times past, low vacancy would usually cause landlords to be a bit complacent, but partly because of the disruption caused by serviced office providers, landlords looking for longer-term tenants have to think really hard about the quality of space they are providing.”

Patel observes that while many occupiers are demanding flexible leases that allow them to adapt during a period of rapid change, the trend is counterbalanced by a number of larger tenants seeking the stability of a long-term commitment. “If they have 3,000 employees, they do not have many choices, so when they get space they want to lock it in, but even big office towers have funky fit-outs with more communal space,” he says.

“There is a lot of growth potential in Europe, especially in rent-to-consumer models”

NISHANT BAKAYA
CA Ventures

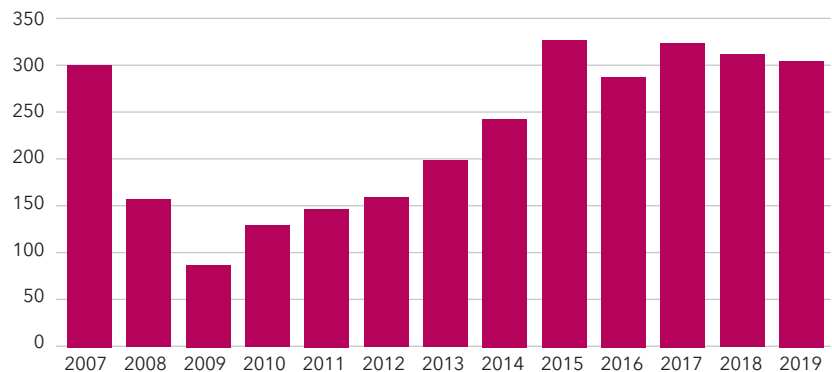


The year ahead

As the participants close the session with their top predictions for the coming year, the atmosphere of growing public alarm over the climate crisis makes it inevitable that the industry’s commitment to sustainability will take greater importance. “I am hoping it will be a year of radical awakening about our responsibilities as landlords and also the business models of our occupiers. How do we accommodate vast population growth and urbanization in the built environment without damaging the planet?” asks Oram. He contends that given the relative wealth of European economies and the current lack of federal government support for environmental action in the US, it will fall to European property markets to trail-blaze sustainable approaches.

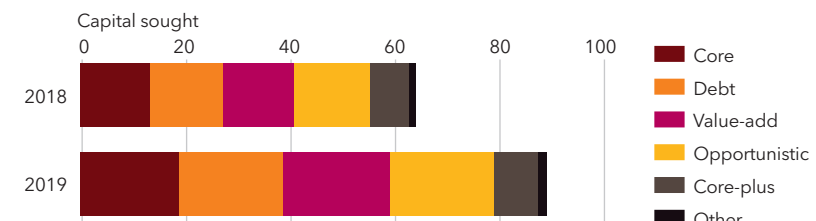
Pearce predicts that in a matter of years real estate will reach a “tipping point” when buildings with poor environmental credentials will fall in value. “We were aware in 2010 of the challenges the retail sector was facing because of the impact of e-commerce, but it was still a number of years before we

A strong finish to 2019 saw European deal volumes almost match 2018 levels (€bn)



Source: Real Capital Analytics

In 2020, fundraisers for pan-European vehicles are seeking more equity for core, value-add and debt strategies than last year (\$bn)



Source: PERE



“The big question is how does capital adjust so that it can be active in the market?”

KIRAN PATEL
Savills Investment Management



“We were aware in 2010 of the challenges the retail sector was facing because of the impact of e-commerce, but it was still a number of years before we saw the drop off in investor demand and it will probably be the same with sustainability”

DAVID PEARCE
Nuveen Real Estate



Student accommodation acquired by DWS: expected to meet modern student demands

Five key deals

The participants highlight transactions in the past 12 months that reflect major property trends

ORAM

UK shopping center REIT Intu and co-owner Canadian pension fund CPPIB sell Intu Puerto Venecia shopping center in Zaragoza, Spain, to Italian investor Generali's Shopping Centre Fund and German fund manager Union Investment Real Estate for €475.3 million in December 2019

His analysis: That was interesting not only because of the motivation of Intu to sell – it is trying to repair its balance sheet – but also because the pricing achieved clearly demonstrates the need to be forensic about how we differentiate assets in the retail sector. It sustained good pricing in what has been a tough market for retail assets.

BAKAYA

Deutsche Bank-owned asset manager DWS's August 2019 purchase of a £600 million (\$782 million; €707 million) portfolio of purpose-built UK student housing from luxury student accommodation provider Vita Group

His analysis: Several generations of student accommodation have been delivered in the UK and most of it does not provide the in-unit and community amenities and life-safety systems that you expect for modern student demand, which puts it at risk of obsolescence. This portfolio had the quality, locations and amenities to appeal to a core buyer looking for best-in-class student housing that is going to hold and increase its value while providing an attractive risk-adjusted cash return.

PATEL

Vienna-headquartered property company Immofinanz's acquisition of the 49-story Warsaw Spire office tower from Belgian investor-developer Ghelamco for €386 million in July 2019

His analysis: Western European investors chasing yield are being pushed out to smaller, more volatile markets like Warsaw, Dublin and the Italian cities. It also tells you something about relative pricing, because that deal was done at a yield in the 4 percents, which is unprecedented for Warsaw, but still attractive compared with 3 percent in Paris or Munich.

TRAN

WeWork's acquisitions in the central London office market, which have enabled the serviced workplace provider to establish over 50 locations and become the city's largest private office tenant

His analysis: Recently WeWork has pulled back from some commitments or gone into fund or equity co-investment type structures with capital providers so space is not completely on their balance sheet, which decreases their exposure to long-term lease liabilities. That is something we will probably see more of from them and from other operators in the sector, but whether or not WeWork turns out to be a success under its new leadership, it is a harbinger of more activity to come from innovators and disruptors.

PEARCE

Blackstone's launch of the Mileway urban logistics platform in September 2019 and its acquisition of UK-listed industrial property company Hansteen's £451 million portfolio in December

His analysis: Lots of other investors are betting on urban logistics, but the speed and the number of transactions that Blackstone did to create a 100-million-square-foot pan-European platform with 1,000 properties was very impressive. They did something similar with industrial platform Logicor and then exited by selling it to China Investment Corporation. It will be interesting to see if this ends up as a listing, or a partial or full exit for Blackstone.

“We are seeing a proliferation of core funds in Europe, and debt funds are also growing in popularity”

JASON ORAM
Europa Capital



saw the drop off in investor demand, and it will probably be the same with sustainability,” he says.

Meanwhile, Tran expects investors to maintain their appetites for real estate in 2020. “One of the reasons why we see a lot of our clients go into investment funds is because of opportunities and dealflow. They want to do deals alongside the fund by co-investing or deploying through sidecars. Fundraising may go up and down, but I still see a huge role for fund managers in the market going forward.”

Bakaya foresees that capital in Europe will increasingly be allocated to emerging asset types like multifamily, student housing, senior housing, self-storage and data centers. “There is a lot of growth potential in Europe, especially in rent-to-consumer models,” he says. “These alternative asset types are increasingly proven and managers are replicating models that have gone well in other parts of the world.”

None of the participants anticipate a major systemic shock in the near future, but Patel sounds a note of caution. “Given

past experience, when you are underwriting deals today, I think you have to factor in some sort of dip at some point. I don’t think the market is unbalanced in terms of the supply-demand fundamentals, but I also don’t think you can disregard a demand shock. I don’t know what might cause that, but some form of correction may follow the equity market, or the junk bond market, or indebted governments defaulting.”

The catalyst for a downturn could be a crash in technology-related shares, muses Oram. “The outlook in terms of real estate fundamentals looks really positive, but pricing is vulnerable. It is most vulnerable to a revaluation of some of the big disruptive stocks that are out there. I wonder when the inability of those businesses to generate profit is eventually going to affect their market capitalizations.”

Such concerns will be of little material consequence to European real estate investors in the short term, however. For the foreseeable future, the most pressing issue at hand will be how to deploy capital in a market where supply is tighter than ever. ■



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