PERE

Investor Perspectives 2020

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Investor Perspectives 2020

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Insight

Seven investor perspectives that matter **Our PERE Investor Perspectives 2020 Survey offers valuable insight into allocations, strategies and concerns for the year ahead**

In fundraising terms, 2019 appears at first glance to have been something of a disappointment for private real estate, with the asset class registering its second-lowest figure for seven years at $135.27 billion. And the number of funds closed in 2019 has dropped off dramatically too – just 181 at year end, down from 337 in 2017. So, has the sheen been wiped from real estate? Are investors side stepping the sector? Not necessarily.

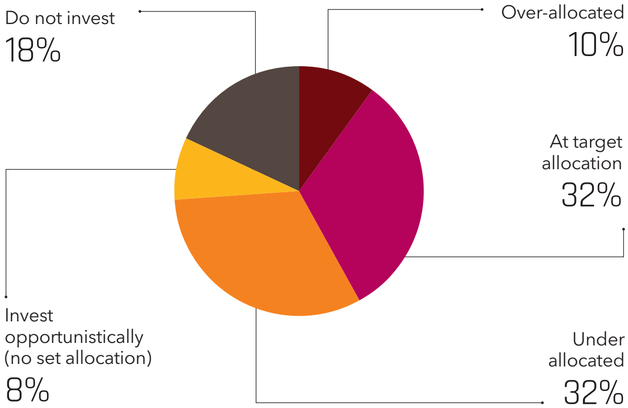
Recent *PERE* analysis of these year-end figures suggests simply that more capital is being concentrated in the sector's mega-funds. And certainly, the findings of this year's *PERE Investor Perspectives 2020 Survey* indicate a healthy appetite to allocate capital to the asset class in 2020, and optimism about its expected performance in the year ahead. Now in its second year, the survey aims to get to the crux of the challenges, issues, pain points and opportunities that investors will face over the next 12 months.

The following charts highlight the seven big themes that are front of mind for private real estate's investors.

UNDERALLOCATED TO THE ASSET CLASS

When it comes to current allocations to the asset class, approximately one-third of private real estate investors polled for the *Investor Perspectives Survey* indicated they are at their target level. This is similar to the findings in last year's survey, when 35 percent of respondents felt they had reached allocation targets. Perhaps more revealing, however, is that far more investors this year say they are currently underweight in the asset class – 32 percent in the 2020 study compared with 18.9 percent in the 2019 study. This notable proportion of investors leaves the market with a gap between current and target allocation, and sets investors up nicely to shift more capital into private real estate in the year ahead.

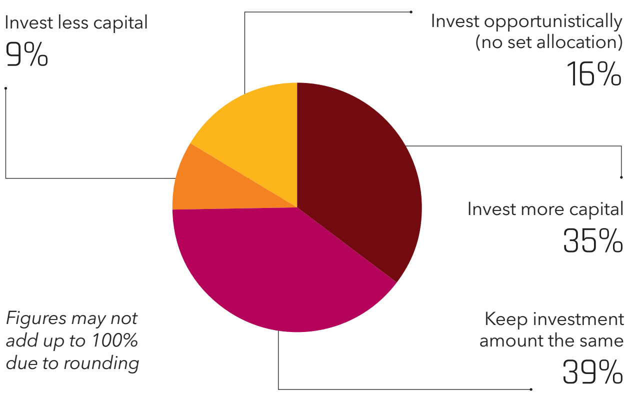
What is your current allocation position for private real estate?



DEMAND FOR REAL ESTATE

Given that a significant number of investors surveyed this year feel they are still under-allocated to the private real estate asset class, it may not come as much of a surprise to learn that the majority of those polled are planning to maintain or increase the amount of capital invested in the sector over the next 12 months. Thirty-five percent of respondents say they will look to increase capital commitments in the next 12 months, with a mere 9 percent expressing the wish to allocate less capital in 2020. Thirty-nine percent expect to invest the same amount in 2020 as in the prior year. These figures suggest positive investor sentiment toward, and a healthy level of confidence in, private real estate.

How much capital do you plan to invest in private real estate in the next 12 months compared with the previous 12 months?



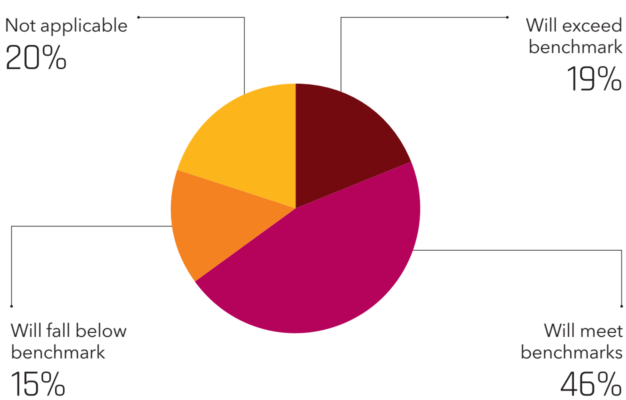
Figures may not add up to 100% due to rounding

GOOD EXPECTATIONS

Reinforcing the previous positive sentiments revealed by the survey are the findings on expectations of performance. *PERE* asked investors to comment on how the private real estate asset class would perform their against benchmarks in the coming 12 months.

Nearly half of respondents reveal they expect their private real estate investments to meet benchmarks, while 19 percent of investors believe the performance of their private real estate portfolio will exceed benchmarks in 2020. Only 15 percent believe real estate investments will fall short of their expectations.

How do you feel private real estate will perform against its benchmark in the next 12 months?



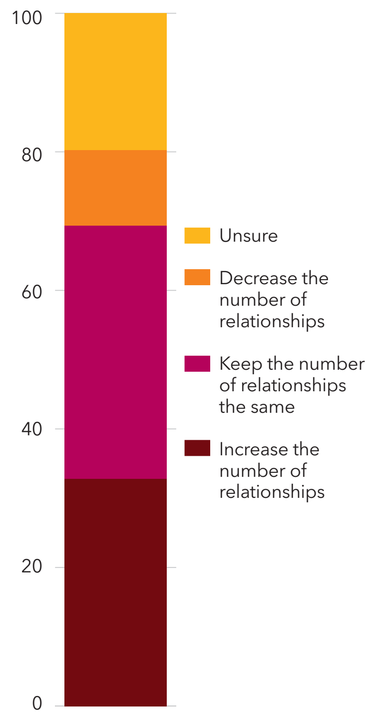
LOYALTY DEFINES RELATIONSHIPS

Investors are moderately receptive to increasing the number of manager relationships for their private real estate portfolio – 33 percent of respondents are open to the idea in the year ahead compared with 37 percent in last year's survey. And compared with sentiment for other asset classes, investors in private real estate are the most cautious about forming new partnerships – 41 percent are looking to ramp up the number of managers they work with in private equity and 40 percent are seeking to do the same in infrastructure.

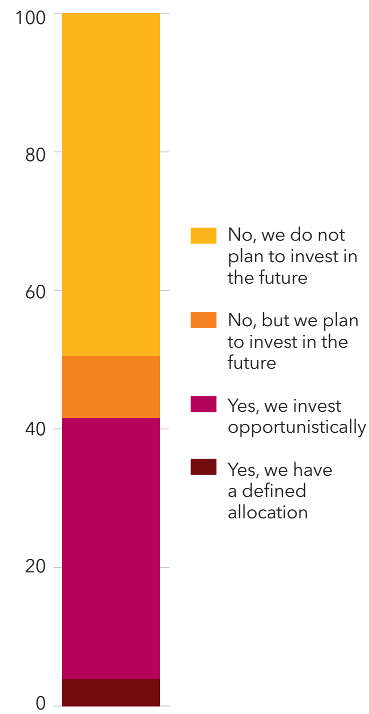
The idea of allocating to first-time funds is not embraced either with 50 percent of respondents expressing no intention of doing so in the future, although 38 percent report they do so opportunistically.

Overall though, the asset classes capitalizers are a loyal bunch and stick with the familiar.

Thinking of your current fund manager relationships, would you like to increase, decrease, or keep the number of relationships the same? (%)



Do you invest in first-time funds? (%)

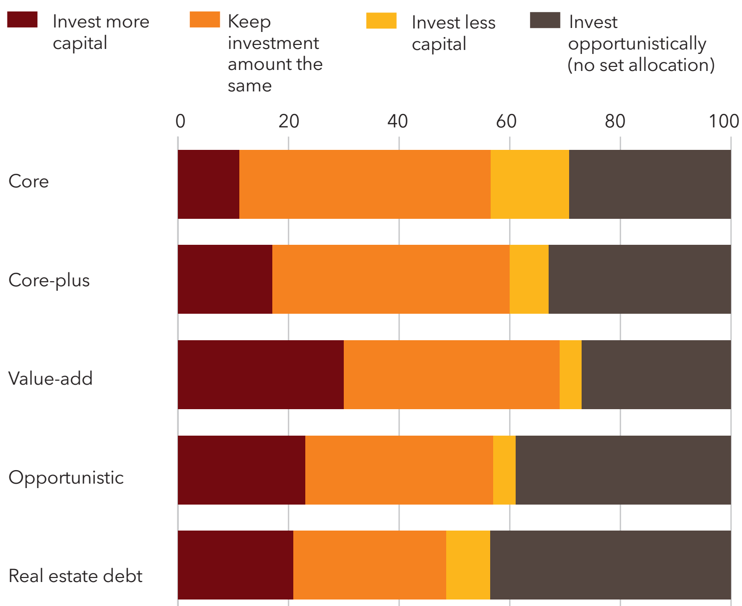


RETURN SEEKERS

Overall, across all strategies, investors say they are most likely to maintain the amount invested or invest opportunistically. Changes across the fundraising landscape, such as a dip in the number of funds raised from 2013-19, have partly contributed to a slow-and-steady sentiment toward the asset class.

However, it is where investors are most likely to increase capital in the next 12 months that is most revealing – 30 percent intend put more capital to work through value-add and 23 percent through opportunistic. Debt is the third most popular strategy, with 21 percent of investors polled looking to invest more in 2020. This compares with just 11 percent for core and 17 percent for core-plus. Investors are willing to move up the risk curve to achieve higher returns.

Regarding private real estate, how much capital do you plan to invest in the following strategies in the next 12 months compared with the previous 12 months? (%)

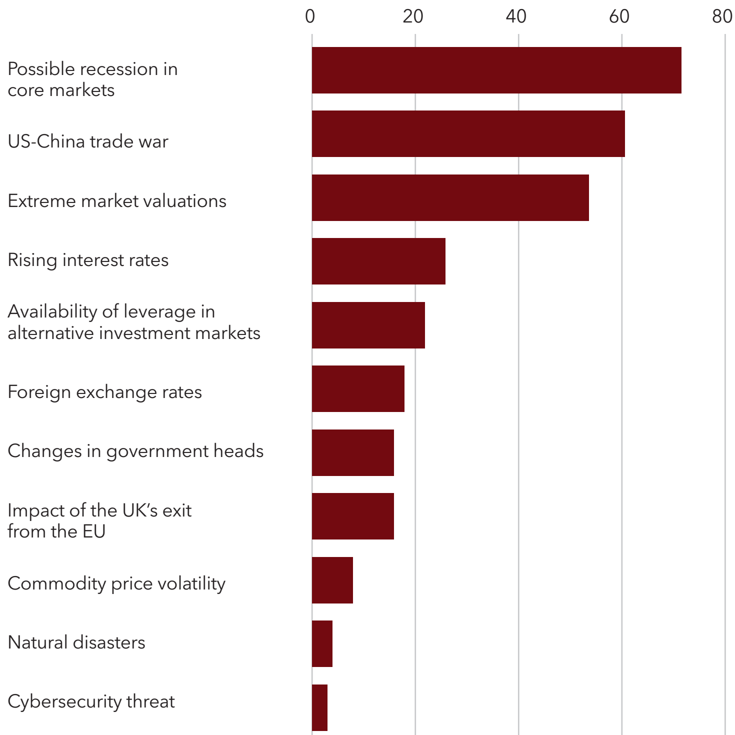


RECESSION IS A LOOMING CONCERN

Private markets do not operate in a vacuum, so we also asked investors their thoughts on the macroeconomic factors they believe will have the greatest impact on the performance of their investment portfolios in the year to come.

Investors anticipate a possible recession and a US-China trade war will have the greatest impact, followed by extreme market valuations. Availability of leverage, which can amplify possible returns but also multiply the potential downside risk in the event of the investment not going according to plan, also features. Threats in the form of Brexit, natural disasters and cybersecurity are cited as less likely to impact performance.

Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months? Multiple responses accepted (%)

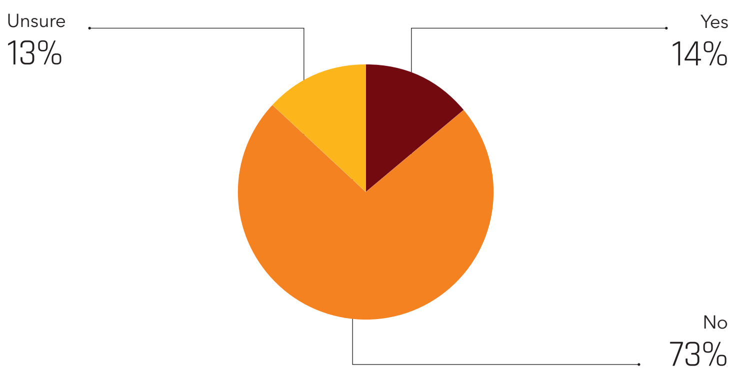


ESG AND DIVERSITY FAILING TO IGNITE

Arguably the findings from the *Investor Perspectives Survey* that might be of most concern – indeed, surprise – are those relating to ESG, and diversity and inclusion. Both subjects have become core talking points for both real estate investors and managers in recent times. But is the talk backed up with practical action to push these agendas forward within the sector? Our survey findings would indicate otherwise.

ESG and diversity and inclusion form a major part of due diligence for just 31 percent and 23 percent, respectively, of investor respondents. Fifty-four percent say they do not actively engage managers to promote diversity and inclusion, while a whopping 73 percent say it has not been a deal breaker.

Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?



31%

Investors report ESG is a major part of their due diligence

23%

Investors say diversity is a major part of due diligence

Editor's letter

Property's appeal holds steady

Helen Lewer
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Anyone checking in on *PERE*'s latest fundraising figures might be forgiven for thinking investors have lost a bit of faith in private real estate in the last 12 months; $135 billion was raised in 2019, the second lowest figure recorded in seven years. The number of funds closed fell significantly, too – 181 compared with 337 just two years ago. So should the asset class prepare itself for a subdued 2020?

Narratives can, of course, change quickly and data from a year gone by is not necessarily an accurate barometer of what lies ahead. And certainly, the findings of our *Investor Perspectives 2020 Survey* indicate that institutional interest in private real estate is very far from down and out.

“The findings of our survey indicate that institutional interest in private real estate is very far from down and out”

Just 10 percent of investors polled report they are over-allocated to the asset class going into 2020, with 32 percent saying they are under-allocated. Further, 35 percent of respondents are looking to commit more capital this year. Only 9 percent say they will invest less.

Investors are also largely content with the performance of their investments in the past 12 months, with 56 percent saying the asset class either met or exceeded benchmarks – only 7 percent feel they were short-changed. And neither is there a sense, happily, that private real estate will fail to deliver in 2020, with 65 percent of investor respondents foreseeing benchmarks being met or exceeded. Just 15 percent anticipate performance will fall short.

So despite a quieter fundraising year in 2019, it seems it would be premature to hit the panic button. Private capital is out there and eager to take up residence in property. As one commentator in this report highlights, in a low interest rate environment, real estate is viewed as a “good diversifier and return enhancer.” The year ahead looks set to be a positive one and we look forward to monitoring how it plays out.

Enjoy the report

Helen Lewer
Special projects editor

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KEYNOTE INTERVIEW

A return enhancer

Even at a late stage in the cycle and with global growth slowing, real estate retains a strong appeal to investors, says Savills Investment Management's Alex Jeffrey

Private real estate has had a good run in recent years, providing strong relative performance for investors, which continue to target higher allocations and seek to deploy more capital in the sector. The global economy has been in an extended late cycle and concerns over a coming downturn have become more pointed. But Black Swan events notwithstanding, there is still plenty of cause for optimism. *PERE*'s Mark Cooper talks to Alex Jeffrey, global chief executive of Savills Investment Management, about the outlook for real estate in 2020, and the evolving needs and demands of investors.

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Q How do you expect the global economy to perform in 2020 and how will this affect real estate?
We are in the midst of a slowdown in the global economy, which has been happening for some time and, of course, real estate is tied closely to the wider economy. The economic outlook is more muted than we have experienced in the past decade, and that will affect occupational markets, particularly in the office sector. This has the potential to hit rents and therefore returns. So, investors are right to be concerned. Of course, there are a number of risks out there – financial, political, military and ecological – that could impact real estate markets. Some risks have a cyclical impact, as we are seeing most recently with the novel coronavirus outbreak. Other risks, like climate change, have a structural impact.

These risks are not necessarily all negative for real estate, because the low interest rate environment is persisting. And the more investors expect that to continue, the more capital will be diverted into alternative sectors such as real estate, which have performed well. Investors rightly regard real estate as a good diversifier and return enhancer.

We also see the emergence of real estate sectors, such as multifamily residential, healthcare and student accommodation, which are more insulated from the wider economy and which have more structural drivers. Multifamily, for example, accounts for around 20 percent of US institutions' real estate portfolios, and is attracting interest elsewhere. In some respects, it is also counter-cyclical as people are more inclined to rent in a downturn. So, we are tracking the sector across the key markets and are quite heavily involved in Japanese residential, which has become an established institutional sector.

Q The *PERE Investor Perspectives Survey* shows many investors consider themselves under-allocated to real estate and are keen to invest more. Is there a risk inherent in the glut of capital targeting the sector?

Investors need to understand that in the absence of a positive shock, returns will generally be lower than in the past. But those returns may well be better than those generated from investing in other asset classes, so this needs to be looked at on a relative basis. The spread over the risk-free rate in most countries is still attractive and significantly above the previous peak in the cycle. There is room for that spread to fall further and therefore for returns to continue to be attractive on a relative basis when compared with other asset classes.

Q There appears to be more interest in value-add and opportunistic strategies, and appetite for investing opportunistically in real estate debt. What is driving these preferences?

Investors are looking for potentially more risk and higher returns, probably because core returns have come down. We would be quite cautious about how wise that is given the more subdued economic outlook. Value-add strategies still work in certain selected markets, where managers have strong access to off market deals at attractive pricing, and in markets with a beneficial imbalance of demand and supply. Generally, however, value-add and opportunistic strategies normally require quite strong economic and employment growth to exceed their target, so investors need to be selective about how they access those types of strategies. From the investors we have spoken to, it is clear risk appetite depends on their existing book. Investors that have established a well-diversified base of core assets will at a later stage look to invest in more higher-risk strategies or more sector-specific bets.

We are also seeing a significant uptick in interest in real estate debt. This is obviously a relatively newer way to access real estate,

Under the microscope

Alex Jeffrey highlights the key areas of a manager's business coming under more intense scrutiny in investor due diligence

Fees are an ongoing topic and there is pressure on fees, but experienced investors look at this in a sophisticated way. They are more concerned about potential returns after fees than just absolute fees. Investors are also expecting managers to be more creative about how they share risk and reward. There is a lot of discussion about the balance between base fees and performance fees, so the manager is aligned with the investors to a high degree.

We see more pressure coming from investors in other areas. For example, more detailed questioning on operational due diligence. Looking back five years or more, investor due diligence would focus more on a manager's real estate skills. Obviously that is still the case, but there is now a far more wide-ranging analysis of the operational side of a manager's business, including the overall approach to risk management, the compliance framework, IT and cybersecurity and the whole investment process. Quite rightly, investors want to make sure there is a very robust infrastructure around the investment and asset management teams.

Eye on the team

There are also more questions about the make-up of the team, especially with regard to diversity and inclusion. How do we go about recruiting and retaining people? What is the culture of the organization? We get much more broad-ranging and searching questions than used to be the case.

For smaller managers, it is getting increasingly difficult to demonstrate to large institutional clients that they have the infrastructure needed with regard to risk management, compliance, technology and ESG. There will still be a place for sector-specific niche players, but if they are successful they will often be drawn into tying up with larger players. So, there is an inevitable process of consolidation going on, partly driven by the march of compliance requirements, but also by the other operational due diligence investors need. But it is in investors' interests for that consolidation to happen because if you can spread the fixed costs of, for example compliance, risk and ESG over a larger pool of assets, then – all other things being equal – fees should come down, too.

because traditionally banks have done a lot of that lending. It is an attractive way for investors to obtain good risk-adjusted returns, because it gives downside protection, which is reassuring in a late-cycle environment. It is a structural shift as well as a cyclical one, in that it is a fairly recent emerging sector for non-bank players.

Q ESG issues dominated discussions at Davos this year, but the *PERE Investor Perspectives Survey* indicates that this topic is not yet at the top of investors' list of concerns. Does this match your experience?

ESG is moving up the agenda for investors, especially for those in Europe. However, it is starting to spread into mature markets elsewhere, including Asia. It has long been the case that we and other managers have focused on environmental factors such as energy efficiency and the overall carbon footprint of our portfolios given that the built environment accounts for 40 percent or more of global emissions. Benchmarks such as GRESB and the UN PRI are being increasingly used and the focus is now broadening to social factors, such as the contribution investments make to the local community.

Consultants such as Mercer now require an ESG rating in addition to an investment rating when they are underwriting managers' offerings. That is only going to increase. We will get questions not only about how we manage our assets, but also, quite rightly, about how we manage our own businesses responsibly. My sense is that investors looking at this in a sophisticated way will increasingly regard it as aligned with the search for attractive returns. In the past, ESG was regarded as a cost whereas now, there is an increasing realization that such measures are likely to enhance returns over time, both in terms of income and capital value.

This has been partially driven by the growing focus of governments on reducing carbon emissions. We should expect more regulation and differential taxes for the best and worst performing assets from an ESG standpoint.

"Investors are keen to get into Asia because they like the long-term structural growth potential and the diversification it offers"

"Investors are looking for potentially more risk and higher returns, probably because core returns have come down"

Q What is the outlook for European real estate this year, and is Brexit still a dominant issue?

Brexit is very much UK-specific, and while investors are aware there is still a risk of a hard Brexit at the end of 2020, our sense is that it has slipped off the top of the list of concerns about investing in the UK. Investors are somewhat relieved we have a more stable political environment in the UK with a business-friendly government that is also focused on infrastructure investment over the coming years. So, we are seeing an uptick in interest in the UK as a result.

The wider concern about Europe is that growth is expected to be quite subdued in the next 12 to 24 months. However, there has not been a significant amount of development, so vacancy levels, especially in the office sector, are at historic lows in many cities in Europe.

Q What are the attractions of Asia-Pacific, which is once more the preferred emerging market region for real estate investors in the *Investor Perspectives Survey*?

It does seem that Asia is affected more than other regions by cyclical risks – think of the effects of the SARS outbreak, for example. This fact should not be downplayed and must be considered as a risk compared to other regions. Having said that, investors are keen to get into Asia because they like the potential long-term structural growth potential and the diversification it offers. There are very robust fundamentals with regard to urbanization, the rising middle class in countries like China, India and Indonesia, and that these countries can still expect a shift toward service sector output and therefore structural employment growth in the office sector as in more developed markets. There is now also an emerging core sector in Asia. There is a much bigger potential portfolio to go for established investment grade assets across the region, which was not there a decade ago. ■

INVESTOR PERSPECTIVES SURVEY 2020

How we conducted our investor survey

Now in its second year, the Investor Perspectives 2020 Survey is PERE's study of institutional investors' approach to alternative asset classes

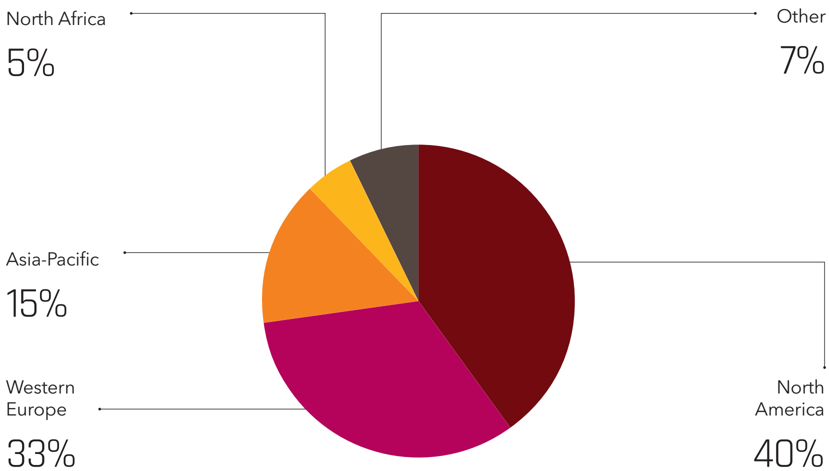
The *PERE Investor Perspectives 2020 Survey* aims to provide a granular view of the alternatives market, both current and future, by gathering insight on investors' asset allocation, propensity to invest and performance predictions.

It is a global study, reflected in the question set and the respondents, which allows for meaningful global views and cross-regional comparisons across alternative asset classes.

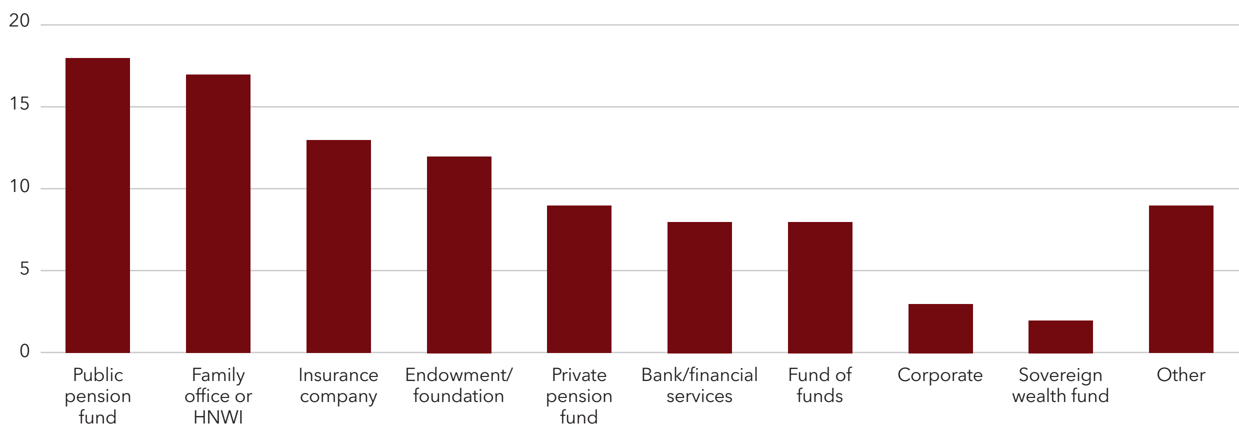
The survey questions are reviewed annually, with the objective of reflecting market developments and shifts in sentiment.

For this edition, *PERE*'s Research & Analytics team surveyed 146 institutional investors. Fieldwork was carried out from August to September 2019. Participation is anonymous, with the findings amalgamated and presented in this supplement. ■

In which region is your institution headquartered?



What type of institution are you? (%)



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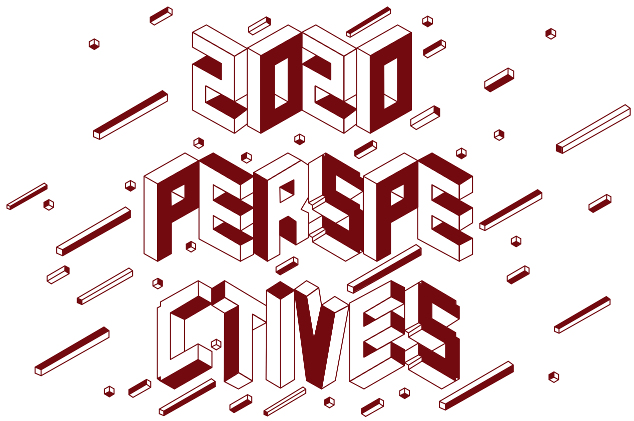


Investors keep the faith in property

Allocations look set to increase in 2020, and while most investors are holding steady on their strategy, many are inclined to take on more risk for higher returns, writes Mark Cooper

The *Perspectives 2020* survey found 35 percent of investors plan to increase allocations to private real estate this year, while 32 percent are under-allocated to the asset class. These desires form part of a trend toward more investment in alternatives: 40 percent of respondents plan to increase the proportion of their portfolio allocated to alternatives by more than 5 percent. A majority of investors also plan to maintain their average commitment size, with a significant minority seeking to increase.

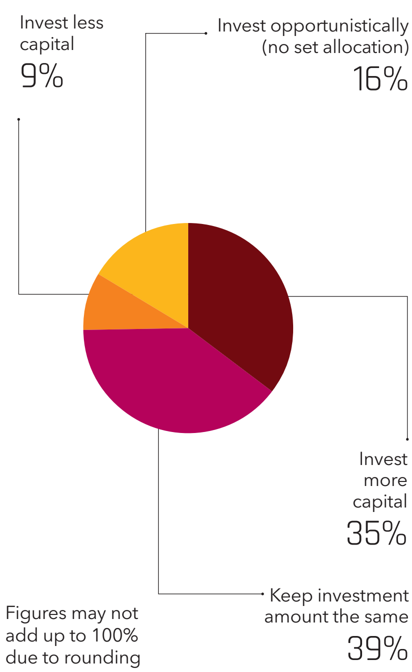
Kiran Patel, chief investment officer at Savills Investment Management, says: "It doesn't surprise me that there's still an underweighting toward real estate. Most models suggest higher allocations to real estate, even as actual allocations have risen from 4-5 percent to 10 percent. However, the models will continually show higher, and that is down to real estate's stable income and diversification characteristics."

Alfredo Lobo, partner at real estate advisory firm Hodes Weill, adds: "The continued popularity of real estate with investors is not surprising in the current low interest rate environment, with lower than expected fixed income returns. We find that increasingly CIOs tend to view real estate as a fixed income alternative."

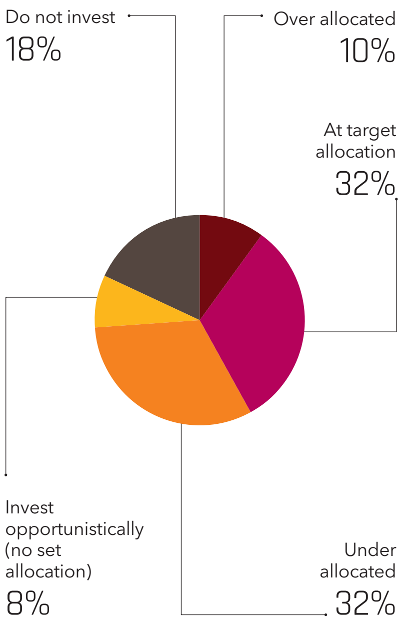
Real estate's popularity is also linked with its performance. The survey found close to 90 percent of respondents who invested in real estate had met or exceeded their benchmarks. Patel says: "Benchmarks have adjusted to the low interest rate, low inflation environment. So real estate has performed as expected, but people have also adjusted their expectations."

Steven Cowins, a fund formation specialist at law firm Greenberg Traurig, adds: "With interest rates and government bond yields being where they are, it is not surprising that anyone holding assets has met or exceeded their benchmark. It's difficult to see now why this low interest rate environment will change. However, this applies to historic assets – the real challenge is making new investments in this economic climate which can meet your target returns."

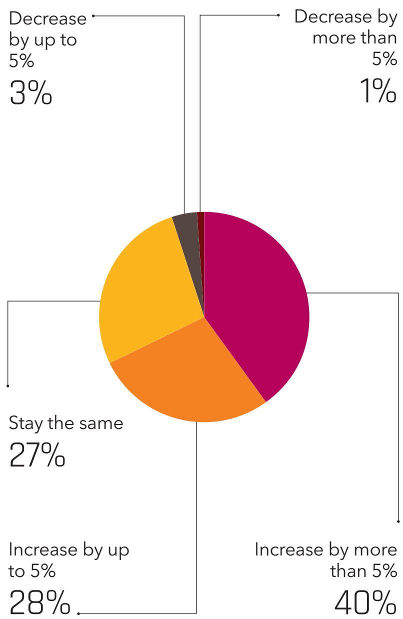
How much capital do you plan to invest in private real estate in the next 12 months compared with the previous 12 months?



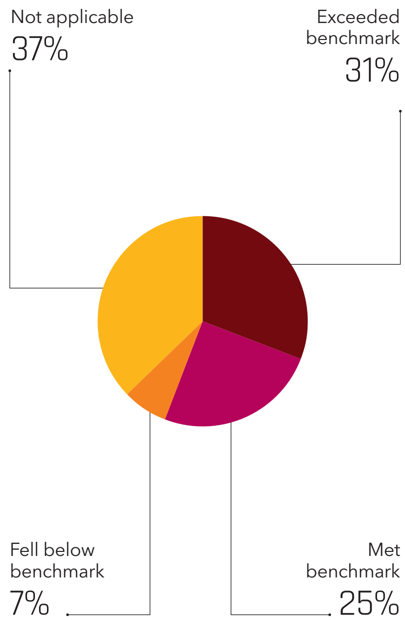
What is your current allocation position for private real estate?



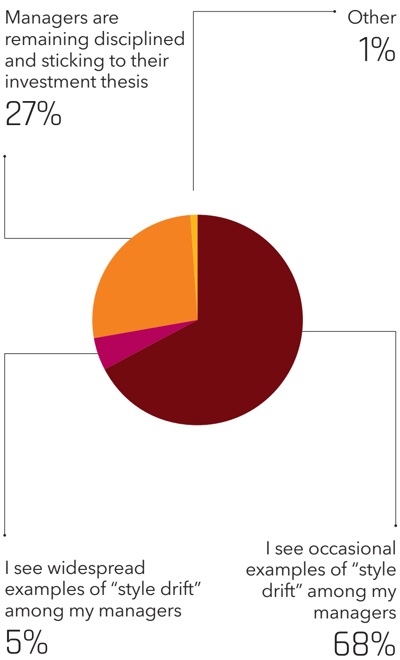
How do you think the proportion of your total assets under management will change in five years' time?



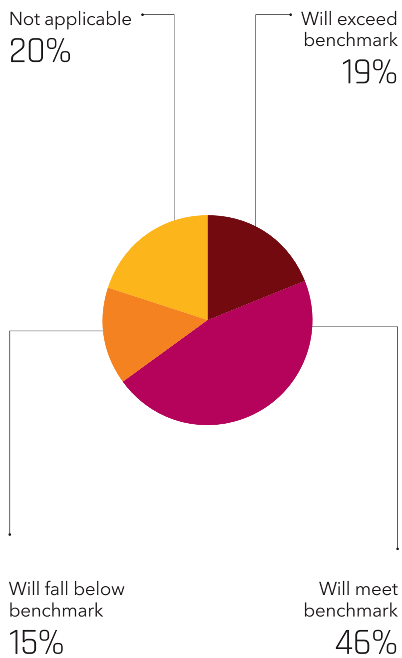
How has private real estate performed against its benchmark over the past 12 months?



Which of the following best describes your assessment of manager investment behavior in the past 12 months?



How do you feel private real estate will perform against its benchmark in the next 12 months? (%)

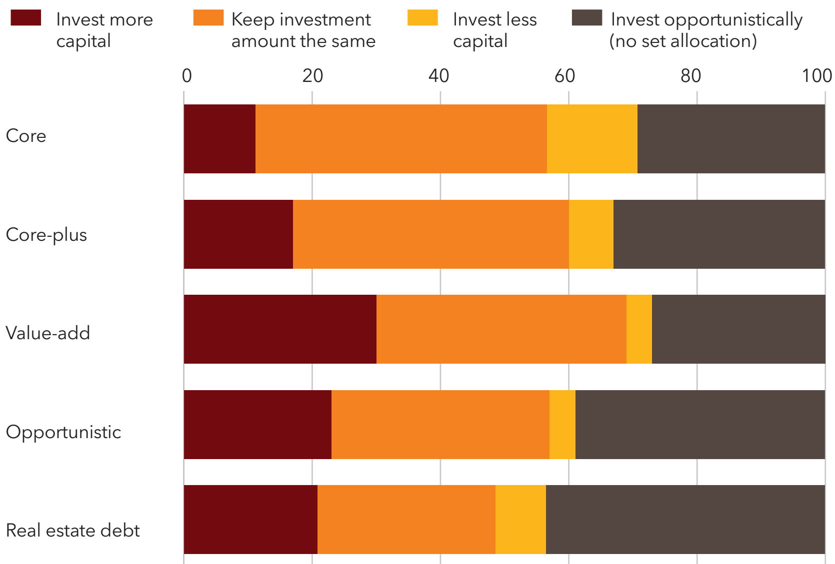


While most investors polled for the survey are holding steady with their real estate strategies, planning to invest much the same as last year, there is also an inclination to take on more risk in the search for higher returns. The survey findings show a trend toward value-add and opportunistic strategies, with 30 percent and 23 percent of investors keen to invest more in these strategies, respectively. There is also strong interest in investing opportunistically in real estate debt.

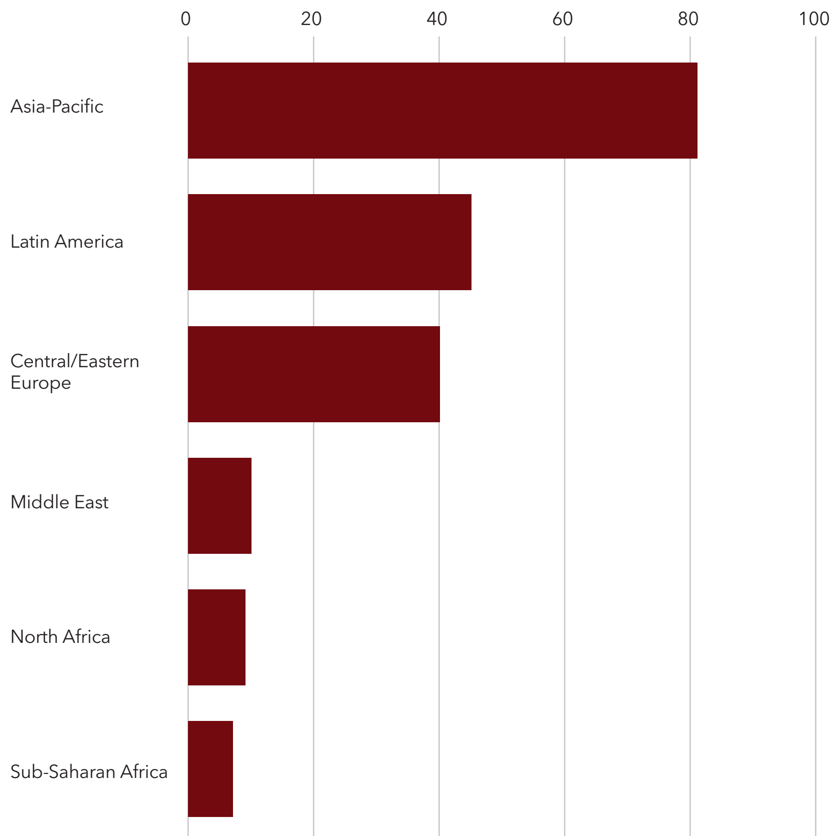
"Given there is little to no yield compression left in most sectors, the main ways of seeking to achieve higher returns are value-add and opportunistic strategies, in particular development, where planning gains drive the performance," says Cowins.

However, Patel says: "A lot of insurance companies and pension funds have guaranteed liabilities to meet in this low interest rate environment, so are seeking to enhance returns from real estate. Also, as institutions become more familiar with real estate, they become more comfortable with moving up the risk/return curve. That said,

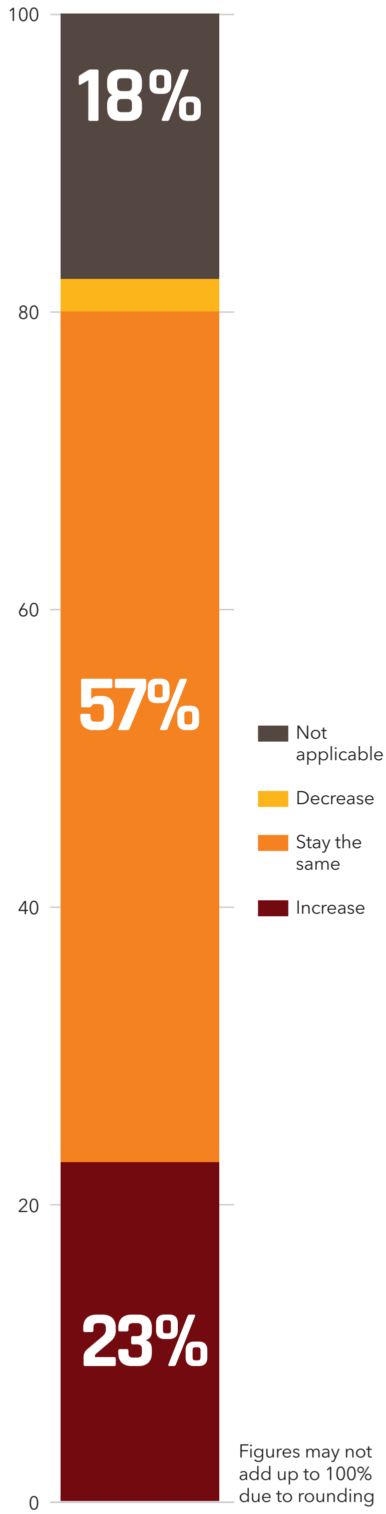
Regarding private real estate, how much capital do you plan to invest in the following strategies in the next 12 months compared with the previous 12 months? (%)



Which of the following emerging market geographies will you consider for investment over the next 12 months? Multiple responses accepted (%)

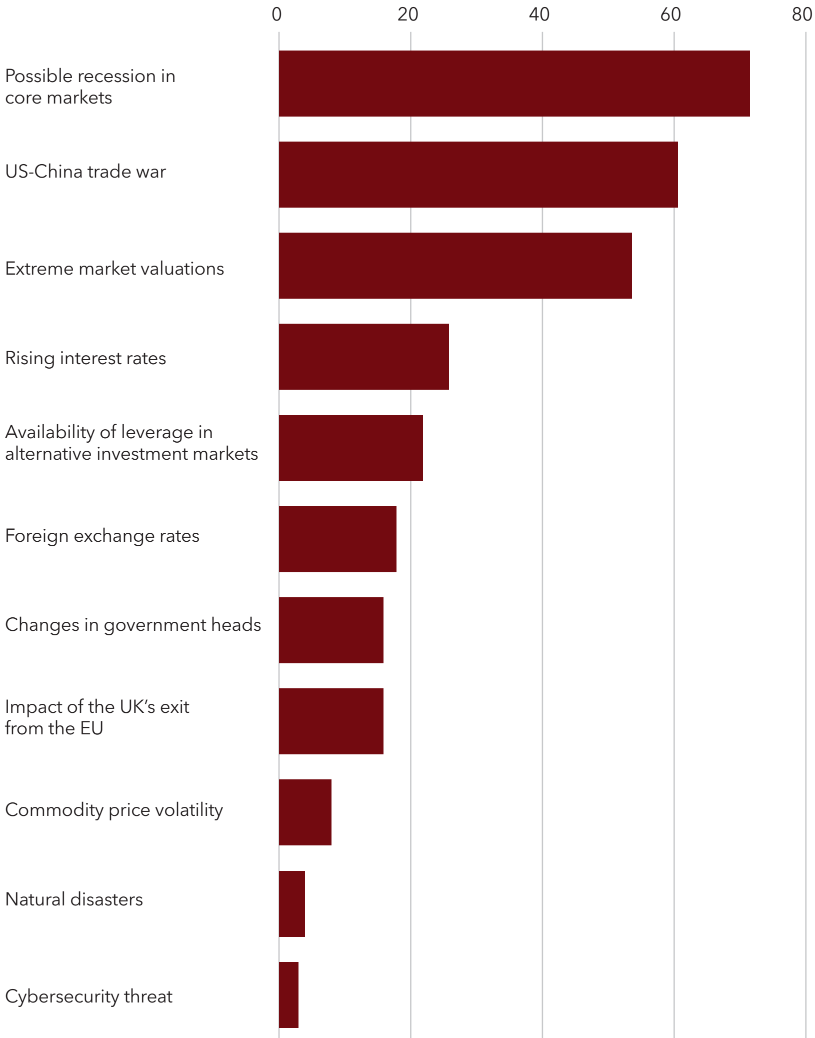


How will your average commitment size to private real estate change over the next 12 months?

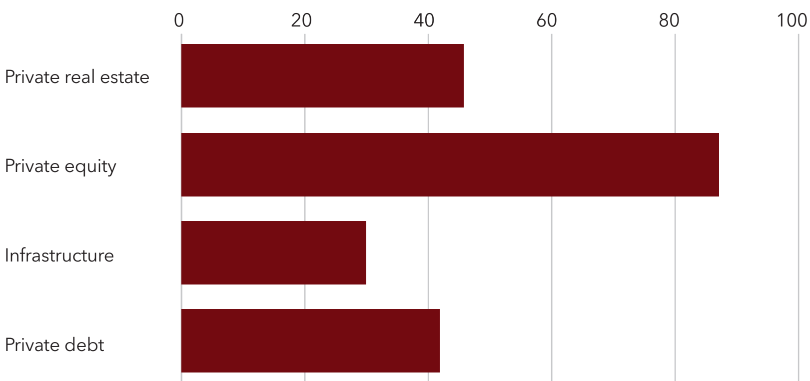


Figures may not add up to 100% due to rounding

Thinking of your private markets portfolio, which three factors will have the greatest impact on performance over the next 12 months? Multiple responses accepted (%)



On average, how many fund opportunities are presented to you per year?



Source for all data: PERE

I don't believe there is widespread appetite for more planning risk or construction risk, or other strategies that would significantly increase volatility."

An eye on the red flags

The three most significant threats to performance currently playing on investors' minds are a possible recession in core markets, cited by 72 percent polled for the survey; the US-China trade war, which is a concern for 61 percent; followed by extreme market valuations. Patel comments: "Capital markets are very much interconnected, so factors such as the US-China trade war cannot be ignored. It is important to assess the secondary and tertiary effects on portfolios. There are other trade issues to come with Brexit, and in geopolitical terms the Middle East situation is one to watch – oil prices are an important inflationary factor in markets where oil is largely imported."

Cowins argues it is "difficult to see which macro event could unsettle the markets, but this is the definition of trying to predict a black swan." However, he notes that: "Given the limited amount of product and the pricing driven by low interest rates and a dysfunctional bond market, the real risk is managers lose their discipline and overpay for assets.

"The real problem is it is difficult to see where a recession could hit and whether it will be market-wide or whether we will have mini cycles in the market, such as we have now with retail continuing to fall, but logistics and industrial are having a boom."

Investors were also asked if they see evidence of style drift from their managers. While only 5 percent said they saw widespread evidence of this, a further 68 percent said they saw only occasional examples.

"We do not see evidence of style drift among real estate investment managers," says Lobo, "although they may add capabilities, as for example a number of managers have launched Asia-Pacific core strategies in recent years. We find investors are happy with managers of value-add or opportunistic strategies moving into the core space, but not so keen on movement in the opposite direction."

Cowins adds: "The private equity real estate managers I act for are extremely disciplined and I don't see style drift." ■

KEYNOTE INTERVIEW

Appetite for debt is growing in Europe

DRC Capital's Dale Lattanzio explains why alternative lenders are becoming more popular in the region's private real estate investment market

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DRC Capital, a commercial real estate debt advisory platform based in London, has seen a spike in enquiries following the UK general election in December last year – 50 percent more than in January 2019 – says the firm's managing partner Dale Lattanzio, a sign perhaps of the market's renewed confidence from having more clarity on the direction of travel of Brexit. Investors again seem ready to deploy capital. Lattanzio talks to *PERE*'s Noella Pio Kivlehan about how the real estate debt space has changed over the last year and offers up his predictions for 2020.

Q Describe the appetite for private real estate debt over the last 12 months? And which types of investors are particularly interested in this part of the market?

Private debt is gaining more acceptance as a true alternative to traditional bank lending across the European real estate markets. And by far and away the investors looking to gain exposure to private debt are the UK- and continental Europe-based pension funds, both corporate and public, and insurance companies.

But the trend we are really seeing playing out now is that the range of debt product offerings is broadening – alternative real estate lenders, like ourselves, are not only offering high-end mezzanine lending, but whole loan and senior lending. What is also changing is that the allocations from pension funds and insurance companies are no longer isolated to the real estate allocation; it is also coming now from fixed income, particularly into the senior strategies. This a natural evolution because the fixed income market and fixed income investors, given the low interest rate backdrop, need to look further afield for the kind of yields and incomes required for their portfolios.

Q What type of lending strategies are in demand, and why?

As the private debt market has matured in Europe for alternative lenders – it is now an established part of the financing market in the region – the ability to provide a one-stop solution to borrowers is increasingly requested. So, rather than go to a senior bank for a senior loan and an alternative lender for the stretch senior or mezzanine portion, borrowers are increasingly looking to alternative lenders to provide the totality of their requirements.

The reason for this is partly ease of execution and ease of dealing with a single lender as the project goes through its life cycle. It is just easier to have one lender to communicate with, particularly when it is a value-add opportunity.

The development of a one-stop shop model is again a natural evolution in the marketplace at this point – alternative lenders now provide 25 percent of all the commercial property lending in the UK market, for example.

Q Is it becoming more difficult to deploy capital?

It is harder for equity investors to find deals that will generate the targeted returns required, particularly as the market gets more competitive and the further along in the cycle we move. So this means looking for deals where more refurbishment or renovation work is needed to the underlying property asset and which can physically add value to the asset, because the market itself is not going in simply one direction anymore. This approach is becoming more prevalent and is increasingly important for borrowers that are trying to create a value-add type of return.

It is no longer enough now to rely on the income from property going up or yields compressing over the course of an investment to generate a return higher than the target. For alternative lenders, therefore, we will see this activity from equity investors translate into loan requests, so as they adapt we will see a change in types of lending.

Q How hard is it to lend in European markets today?

Recently, our business has been more active in continental Europe than in the UK. Transaction volume in the UK real estate market has been far lower than the historical norm over the last couple of years, and Brexit has certainly been a contributing factor. My sense is that it was not necessarily the direction Brexit was heading in – UK in or out of Europe – that was of concern to the market. Rather what the market needed was a clear direction either way, so that investors could commit capital on the basis of risks they can understand and underwrite.

DRC Capital has always been active in Europe. Since we began lending, roughly half of all the loans made have been on the continent. But I am seeing other lenders, which were previously more UK-focused, now growing their businesses in Europe. I believe this trend will only get stronger going forward.

This is not to imply that Europe is a safer bet than the UK market right now. There has been just more happening from our lender's perspective, but I also believe we will see increased activity in the UK over the next year.

"The trend we are really seeing playing out now is that the range of debt product offerings is broadening"

2020 predictions

DRC Capital's Dale Lattanzio offers his thoughts on where private real estate debt is heading in the months ahead

- Headwinds will continue to impact the UK retail property sector. Expect to see a similar trend to emerge across continental Europe as the internet continues to take market share in the region.
- Alternative lending options will increase as a greater number of participants move to offer a broader range of product, both in the UK and across Europe.
- Emphasis on green lending will grow with higher requirements on borrowers to ensure underlying assets are meeting or improving on ESG criteria.
- Expect more activity in the UK than we have seen in the last 12 to 18 months, as some of the Brexit uncertainty is taken out of the market.

Q Are there particular property sectors currently attractive to lenders? And are there any parts of the market struggling to attract debt finance?

Industrial and logistics continues to benefit from great liquidity, with both equity and debt more plentiful – the need to serve the changing shopping habits of consumers mean investors are seeing good opportunities in this sector.

Offices, both in London and the regions, are also attractive. There is not tremendous over supply in this sector and nor has there been a lot of speculative development. Offices are in a healthier position than we have seen in different cycles historically, probably as a result of there being less development debt available.

Within residential, PRS (private rental sector) is a market that we can expect to grow in the UK, provided developers can find the sites that make economic sense. DRC Capital believes in the long-term need growth of PRS as the fundamentals for the UK mean more affordable houses are required either to buy or to rent. The BTR (build-to-rent) market is also a growth sector within residential for the same reason, but the problem with BTR is achieving scale because there is a lack of institutional-grade product available.

Retail is the sector struggling most to attract finance, particularly the shopping center segment of the market. That will probably continue throughout 2020 and is clearly a reflection of the growth of online shopping and the consequent decline in rents.

Q Which country markets are interesting right now?

We have always been active in the UK market, however I think due to lower transaction volumes we have been less so over the past 18 months or so. I would expect that to change this year as we have more political certainty, and against that backdrop we feel there will be generally more market activity. For us, countries in western Europe of note are Spain, as well as the Netherlands; these are markets where there was significant bank lending that retrenched rapidly and the markets corrected deeply. The property markets are continuing a recovery and debt liquidity has improved, but is still behind some of the other markets. We are active elsewhere in the region, such as in Germany, France and Italy. We operate slightly more opportunistically in these regions for differing reasons. Property market fundamentals as well as banking conditions vary dramatically from country to country. I do not think our view will be altered this year; we will likely take a similar approach as we have historically.

"Private debt is gaining more acceptance as a true alternative to traditional bank lending across the European real estate markets"

Q Do you see more intense competition among lenders to win financing mandates?

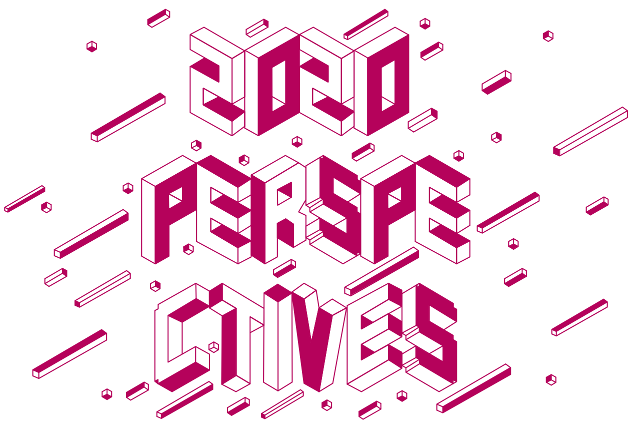
The market is not overly competitive at this point because it is still developing with the non-bank lending element still growing, Borrowers have choices, but it is certainly not out of balance with debt being oversupplied. Further, the lenders operating in the market are all doing very different things. So, not every lender is offering the same products to borrowers – there is a lot of diversity in this part of the market and it is not yet concentrated.

I would expect to see more new entrants but this is still not something that is detrimental, as there is enough overall demand and opportunity. ■

A fast view on green finance

ESG and green lending is set to play an increasing role in the private debt space

Dale Lattanzio: I have definitely seen an increasing emphasis on these issues over the last 12 months or so. Momentum is gathering pace and investors and other stakeholders are forcing through that change rapidly. Green finance has an important role, but the market needs to define clearly what that means and standardize green lending criteria.



Loyalty defines investor-manager partnerships

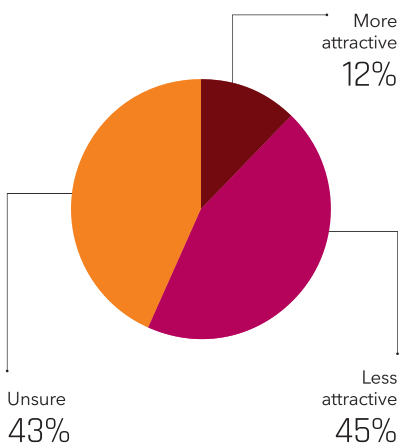
Investors in private real estate largely prefer to stick with their current crop of managers, but are not keen on them selling stakes to outside investors, writes Mark Cooper

Investors appear unconvinced about the merits of managers selling stakes in their business to third parties – 45 percent believe it makes managers less attractive investment partners and only 12 percent say it makes managers more attractive. A significant portion remains uncertain.

However, the trend of managers selling stakes is set to continue, says Alfredo Lobo, partner at real estate advisory firm Hodes Weill. "The increasing volume of stake sales from real estate managers is a reflection of the maturing industry as, for example, business founders seeking a way to realize value while ensuring business continuity and succession planning."

Kiran Patel, chief investment officer at Savills Investment Management, adds: "A manager selling a stake can be positive or negative for its investors. Above all, managers need to be fair and equitable across their investor group, and be conscious of their fiduciary responsibility."

Does selling a stake to an outside investor make a manager a more or less attractive investment partner?



A significant minority, nearly one-third, of investors in private real estate are open to increasing the number of manager relationships they maintain. However, 37 percent want to maintain the same number of relationships and 11 percent would like to decrease that number.

Patel says: "I think to date there has been a tendency to stick with current managers – that is certainly the case for the investors we've been talking to. Naturally, there will be some churn. Size is also a consideration; the infrastructure a real estate fund manager needs, especially if it operates cross-border, militates in favor of fewer, larger managers."

Lobo also says his experience suggests a preference for a smaller number of manager relationships overall. "We consistently find that investors want to do more with fewer managers and concentrate relationships wherever possible. The exception would be when investing in niche sectors – for example, data centers, where they need to look further afield to find expertise."

In line with survey respondents' willingness to form new manager relationships, the survey finds a significant minority – 38 percent – of investors in private real estate are prepared to opportunistically invest in first-time funds while a further 9 percent do not do so at present but plan to in the future. However, half of the respondents report they have no plans to back first-time funds. Lobo's comments suggest investors might also be more likely to back a first-time fund if it gained them access to a niche sector.

Investors show a reasonable degree of confidence in their real estate managers' ability to structure deals sensibly enough to withstand a downturn, with 48 percent confident that their private real estate investments are downturn-resistant.

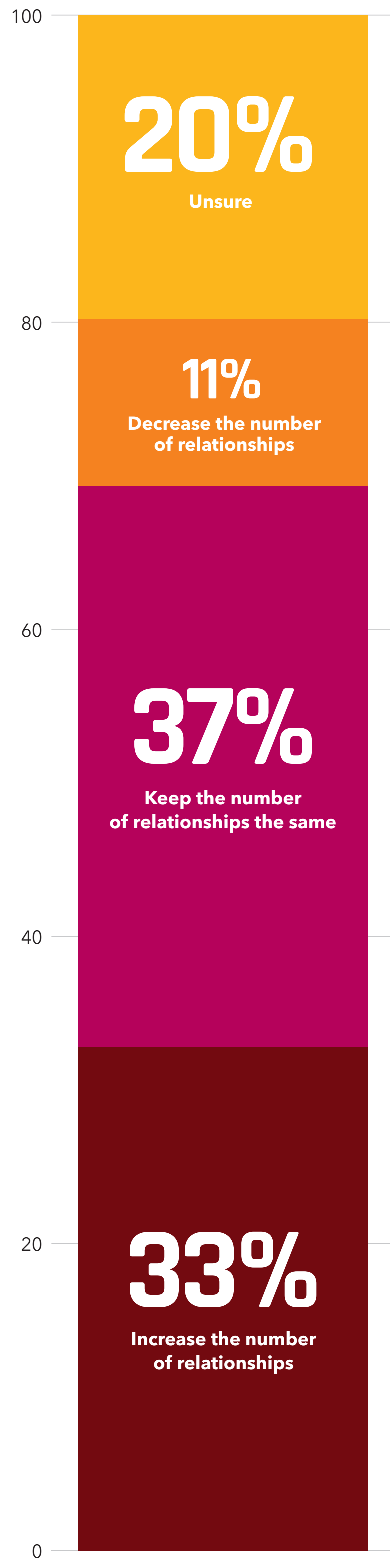
Patel believes managers have learned lessons from the last cyclical downturn: "I think there is a prudence in debt usage, because debt usage brings volatility – no one is going overboard as they did in 2005-07."

He also believes managers have become savvier in structuring their vehicles. "There is much more flexibility being written into structures – for example, open-ended funds have much stronger clauses to manage inflows and outflows, giving managers and investors more flexibility to deal with volatility."

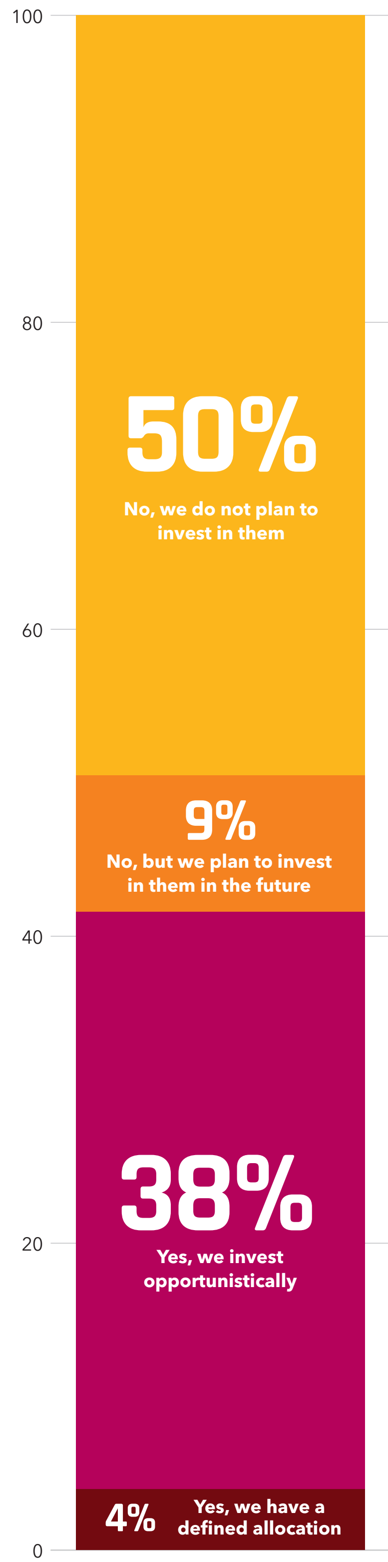
Track record tops diligence concerns

Investors are broadly focusing on the usual areas in terms of due diligence. However, observers expect the relative importance of ESG considerations will grow over time. More than 75 percent of investors consider a manager's performance track record, team size and investment capacity, and terms and fees to be major factors in their diligence,

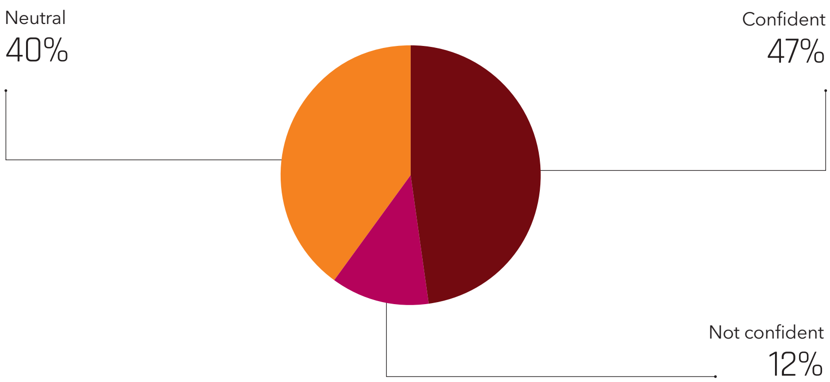
Thinking of your current fund manager relationships, would you like to increase, decrease or keep the number of relationships the same?



Do you invest in first-time funds?



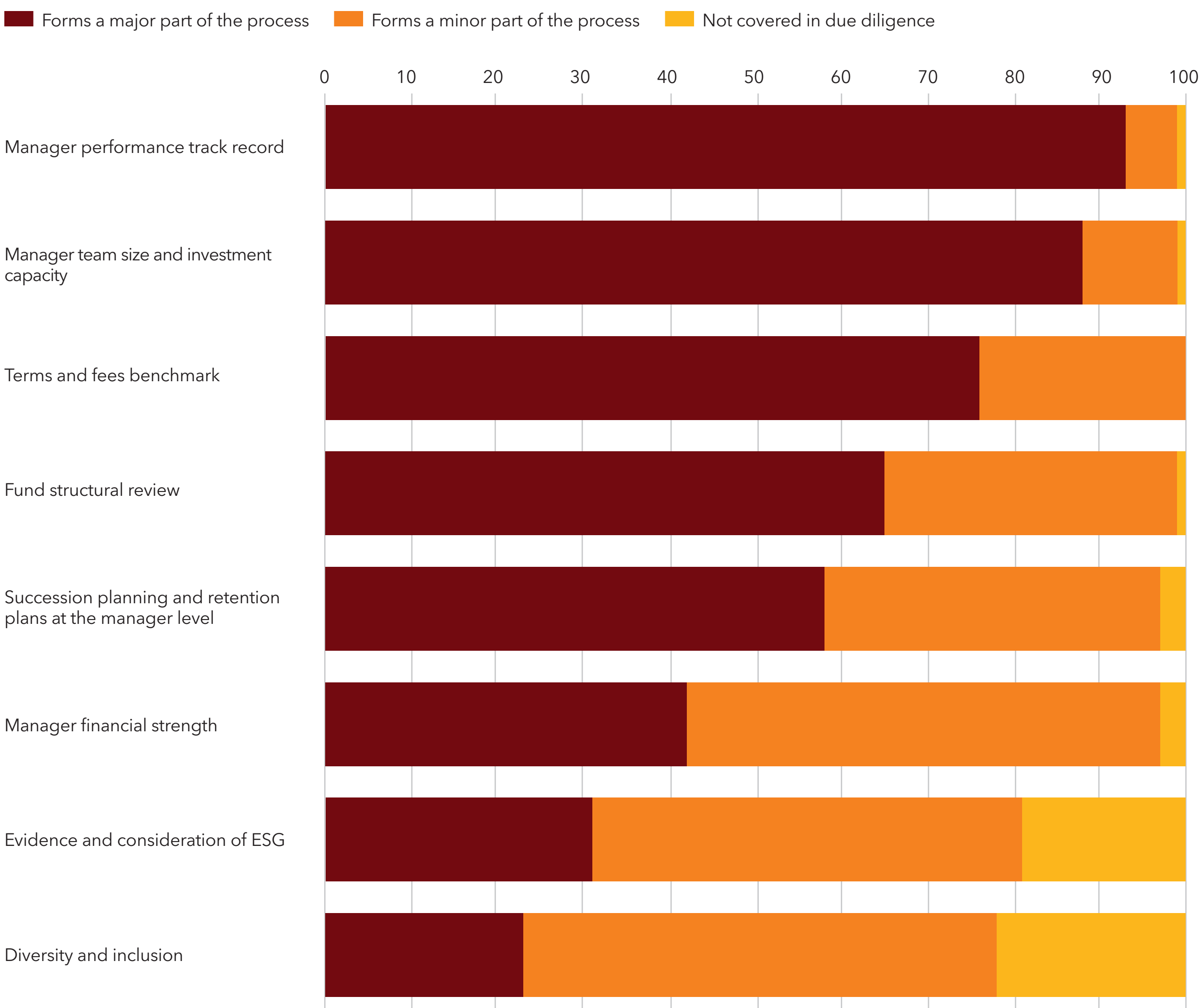
How confident are you that your managers' real estate deals have been structured sensibly enough to withstand a downturn?



with track record a major part of the due diligence process for 93 percent of respondents. However, only 31 percent consider environmental, social and governance issues to be matters of major importance.

Nevertheless, Lobo says: "Sustainability matters are increasingly important in investors' due diligence, particularly for those investors that hail from Europe and Australia, which have embraced ESG. Climate risk is becoming particularly acute for real estate investments, so managers need to be taking a lead on these matters." ■

How significant a part do the following play in due diligence? (%)



Source for all data: PERE

Figures may not add up to 100% due to rounding

Building our futures

Guest comment by **Dr Megan Walters**

Allianz Real Estate's global head of research highlights three trends set to impact commercial real estate investment in the next decade

Government activity and policy in three main areas – fiscal policy, climate change, and technology and infrastructure systems – is set to have an increased impact on the commercial real estate markets and how investors allocate capital in 2020 and beyond. We will see allocations to real estate taking into account locations where governments have fiscal headroom to spend, into asset types that have priced in and fully understood the impact of climate change, and diversification being achieved by investing in real estate on both sides of the technology divide between the west and China.

Fiscal policies and infrastructure investment

The European Central Bank announced in late January it was keeping the main deposit rate at minus 0.5 percent, but not all central banks are following suit. Sweden's Riksbank, for example, ended its experiment with negative rates in December 2019 citing side effects from nominal negative rates, and other commentators are starting to question whether negative rates do more harm than good.

Calls are growing for governments to draw up fiscal policies to spend on infrastructure and climate change-prevention projects. Governments can finance investment projects at negligible costs to promote investment and consumption.

In Australia, government-co-ordinated investment is being undertaken in rail and road systems in Sydney and Melbourne, which is leading to development opportunities in real estate. 'Sydney Central', next to the central train station at the southern end of the CBD, is attracting technology occupiers due to the enhanced Sydney metro and Sydney Light Rail projects. Infrastructure upgrades and enhancements will move desirable locations within cities. This has the potential to benefit real estate by opening up opportunities in both new locations and new product types, such as new mixed-use with city center living apartments.

> *"Governments can finance investment projects at negligible costs to promote investment and consumption"*

Climate change

This is an area of government spending that will likely meet with popular approval. Governments can point to a requirement to spend to avoid financial instability, such as the recent paper by the Bank of International Settlements titled 'The Green Swan', which discussed the physical risk from climate-related damage and the transition risk from the repricing of assets that become obsolete.

In a recent review of trends for 2020, *PERE* also noted that climate change is set to become "an economic issue" for the sector citing, for example, advisory firm Park Madison Partners, which has projected that under a new carbon tax law in New York City, high-emitting properties could see properties cost $20 or more per square foot to operate. While that law will not take effect until 2024, it should be seen as an example of things to come for private real estate and its investors.

5G rollout and technology ecosystems

The risks from uncertainty faced by investors are complex and uncertain, hence the need for diversification. The biggest shift in divergence underway today is in the 5G rollout with governments in the US and China both rejecting technology produced by the other country, with others, such as the UK, becoming embroiled in the issue. This is leading to a clear split in technology ecosystems.

In the Asia-Pacific market, the sheer size of China's tech and mobile industry is likely to impact local markets. In India, about half the country has reliable access to the internet with the other half likely to connect via Chinese-made mobile phones.

Real estate is increasingly a data-dependent industry. For instance, tracking real estate users from their phone locations will allow the dynamic pricing of real estate based on number of users. Being invested in China real estate, to provide exposure to an alternative technology ecosystem, will bring diversification benefits to large global investors. ■

KEYNOTE INTERVIEW

Positivity set to return to UK property

With Brexit uncertainty over and some stability regained, investors are already making more enquiries about opportunities in the UK, says Harry de Ferry Foster of Savills Investment Management

An emphatic general election result for the Conservative Party in December 2019 finally saw some stability return to UK politics. And one noticeable side effect is that investor sentiment in the UK market has spiked in the weeks since. But in this transition year, much work has yet to be done to fine-tune a formal trading relationship between the EU and an independent UK. All eyes will be on how the negotiations between the two sides develop over the next few months and, critically, whether this renewed investor positivity can be maintained.

PERE's Noella Pio Kivlehan talks to Harry de Ferry Foster, co-head of UK at Savills Investment Management, and fund director for The Charities Property Fund, to get his expert take on how the UK real estate market will stand up immediately post-Brexit and throughout 2020.

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Q What does Brexit certainty mean for the UK private real estate market?

Since the 2016 referendum, the market has been subdued – there is no doubt Brexit has restricted new development and decision-making in recent years. In 2019, for example, we had tenants wanting to lease buildings, but in the eleventh hour they just could not get sign-off or they did not have the money to expand or invest. But we have more certainty now.

More positive sentiments started to come through in the middle of January. A CBI industrial survey recently recorded the biggest quarterly swing on record in business confidence since the CBI started conducting the survey in 1958. House building shares are also up 20 percent since December's general election.

It will be interesting to monitor how this translates through to the wider business community and, of course, to property investment, and how long it lasts. We might have a very good first six months in 2020, and then everyone will realize a trade deal still needs to be done with the EU, which might dampen the initial optimism we have

> *"The UK commercial property market is still a favored destination for institutional money with Singaporean, Korean and now German investors particularly eager to get exposure"*

seen at the start of this year. I hope that the UK government will reach a sensible deal with the EU, one that is not too far a departure from the trading relationship we have now, because business generally is afraid of a no-deal Brexit. Businesses like to be able to plan, but a no-deal scenario would make it more difficult to do that.

But at this point, sentiment has improved significantly, and I am optimistic for 2020.

Q How does the UK commercial property market fare against other core markets in Europe? Will UK property be a favored destination for institutional money?

In 2019, there was £23 billion ($30 billion; €35 billion) of foreign investment into the UK property market, and about £40 billion was traded in the UK, which was down from around £50 billion in previous years. We certainly expect these figures to increase this year. The US is by far the largest market for real estate investors. Germany is second, but not by much more than the UK, while the French market, for example, is still mainly dominated by domestic investors.

So, the UK commercial property market is still a favored destination for institutional money with Singaporean, Korean and now German investors particularly eager to get exposure. Since the election, enquiries have increased from Hong Kong, Germany, the Middle East and Israel. London and the UK are finally back on the agenda.

A lot of this interest is driven by income. In the UK, we have gilt rates of 0.5 percent, while government borrowing rates in the likes of Germany and Switzerland are negative – a third of all government rates around the world are showing negative yields. So, we are still seeing a real demand for income-producing assets. Interest rates are also going to continue to be very low for some time yet – in January it was announced they will remain at 0.75 percent – and with inflation and GDP growth also low, having property assets yielding at plus 5 percent is going to be exciting for investors. Further, pension funds still have only got 5 percent exposure to UK real estate, so we may well see them looking to increase that.

Q Is the perception that the UK commercial property market is too London-centric a fair one, or can investors find good opportunities across the regions?

There is little point trying to deny London's strength and appeal to investors. The capital generates 25 percent of the UK's GDP and it is the largest city in Europe, so it has a disproportional effect on the UK economy, and this filters through to the commercial property sector too.

For London, it has been a virtuous circle because it is the political, financial, cultural and technological center, and its where there is occupational demand. However, if prices become too expensive, people move elsewhere. Manchester, Bristol, Leeds and Birmingham are all doing very well, partly because house prices are lower and the cost of setting up businesses is lower. Investors are all about the opportunities, but one of the problems is that while institutions like investing in these cities, the investable stock is limited. Investors end up competing for the few large, super prime offices that exist in these regional centers and as they get hotly contested, investors simply will not get a discount. Occupiers will locate to the regions if it is cost effective – rents and rates are cheap – and the labor pool is good, and that will be supported by housing affordability.

Q As we all know, the retail sector has been struggling globally. What is your assessment of the state

A view on ESG

PERE's Investor Perspectives 2020 Survey **findings indicate investors could be doing more to prioritize this issue in their due diligence. But Harry de Ferry Foster sees real progress being made**

ESG is massively important and it is almost overtaking traditional investment returns as the top priority in some areas. The Charity Commission, for example, recently suggested that charities should look at putting their spare cash to work regardless of returns and should expect to receive lower returns by doing good rather than trying to maximize investment returns. We are getting the big money managers saying to us, 'If you do not have an ethical, sustainability policy then you are not even going to be on the list to invest in.' And I believe this sentiment is only going to strengthen in the years to come. Everyone – private real estate managers and institutional investors included – is going to want to appear that they are doing something and, further, to work to be actually doing something.

"There is no doubt Brexit has restricted new development and decision-making in recent years"

of play of this segment of the UK real estate market? Has the bottom been reached?

Retail makes up 25 percent of all property assets in the UK, but it is not currently on many investors' shopping lists. But there are funds being set up to target retail – private equity firms like Delin Capital Asset Management and Orchard Street have established small retail warehouse funds with around £250 million ($324 million; €297 million) each of capital to deploy.

Essentially, there are two different retail markets – the high street and out of town. The high street remains unattractive because of falling rents, which need to fall further. Of course, the sector has been hit by many problems, such as the internet and the might of Amazon. And a lot of shopping centers have been built in the UK, so oversupply is a big problem now, too.

The high street is not yet ripe for the picking. But it will improve once rents have fallen. It will take time, however, for rents and rates to rebase. Plus no one will be building any retail units because there is simply too much supply.

One area of this market we do like at Savills Investment Management is out-of-town retail warehousing with its relatively affordable rents. Units are let to convenience and discount retailers like Home Bargains, B&M, Iceland Food Warehouse, Aldi and Lidl's – these tenants are paying rents of around £13 per square foot. They also benefit from free parking and will increasingly benefit from electric car charging points. These discounters tend to sell products you would not buy online and because the rents and rates they are paying are much lower per square feet than those paid in the high street, they are sustainable. This compares to the fashion parks, where the rents are in excess of £50 per square foot in some areas.

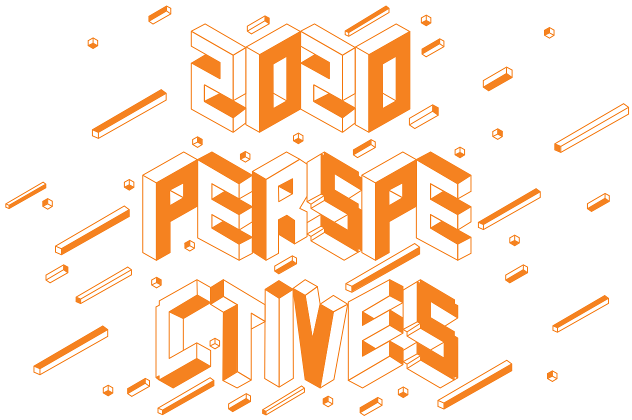
Q From an investor perspective, what other property sectors in the UK are looking attractive?

The office sector is still a good opportunity to invest in currently. Savills Investment Management has just bought an office building in Cheltenham – GCHQ (Government Communications Headquarters) has expanded massively in the town and numerous cybersecurity companies have also based themselves there, and this is generating a lot of demand for office space. On top of which, much secondary office space has been lost through Permitted Development causing a shortage.

Logistics take-up remains good. Internet penetration from retailers continues to grow, albeit at a slower level than in the past, so logistics still has a place. We continue to see demand for just-in-time and next-day delivery.

In the residential space, interest centers around build-to-rent and the private rental sector. But BTR is still an embryonic market and difficult to invest in. Some private real estate managers have said they would build lots of BTR, but have found themselves having to compete with house builders for sites. Unfortunately, developers are overpaying for sites on the basis they are going to get great rental growth, but I struggle to see how they are going to get that if they have paid too much in the beginning, so returns may be disappointing. Nevertheless, investors are expressing interest in these assets, but returns are likely only going to be around 3 percent per annum.

Savills Investment Management favors assets in the office and logistics sectors, particularly in the main urban centers and greater south east of England. Plus more established 'alternative sectors' including hotels, serviced apartments and data centers. ■



Fees are a bone of contention

Investors continue to find it hard to justify mounting costs and are asking for greater disclosure, writes Marine Cole

Investors are voicing their dissatisfaction about the cost of investing in private real estate. Nearly three-quarters of institutions polled for *PERE*'s *Perspectives 2020 Survey* either agree or strongly agree that fees charged by managers are difficult to justify internally. That is up from 63 percent last year, showing a growing bone of contention in the investor-manager relationship.

Further, when asked which terms of the limited partnership agreement caused the most disagreement with managers when conducting due diligence, 49 percent of respondents cite management fees.

Investors have also become more concerned by other fees and expenses outside the management fee and carry. Such fees are usually charged at the investment or property level by vertically integrated managers – those not just focusing on asset selection and investment management, but that also provide property management services and/or brokerage services. They can fall into two categories. The first is fees associated with services from third parties or affiliates hired by a manager. The second is related to services previously carried out by the manager and charged as part of the management fee, but which are now outsourced to a third party for a fee, such as reporting or fund administration.

Robust disclosure

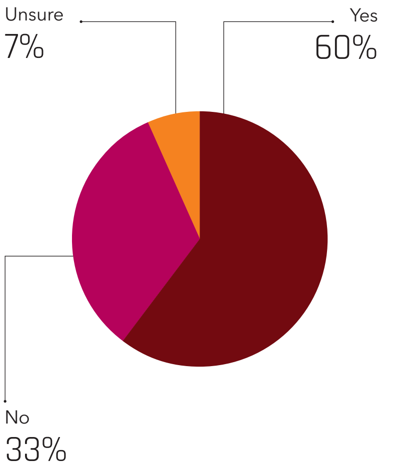
Investors also continue to push for better disclosure around fees. About 60 percent of investors polled say they have asked for greater fee transparency and disclosure from their managers, although this is down slightly from 65 percent in the 2019 survey.

In the US, however, regulators, and to some extent investors, have tended to be more comfortable around the fees and expenses issue since the Securities and

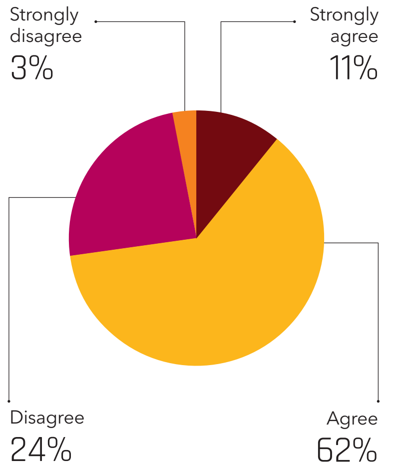
"The charging of property management fees and expenses has not changed, but the disclosure has gotten more robust"

MATT POSTHUME
Ropes & Gray

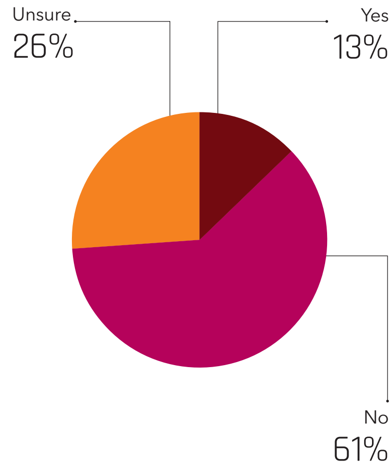
Have you asked for greater fee transparency and disclosure from your managers in the past 12 months?



To what extent do you agree that fees charged by private funds are difficult to justify internally?



Over the next 12 months, are you planning to seek external help when it comes to fee validation?



Exchanges Commission asked real estate fund managers for greater disclosure.

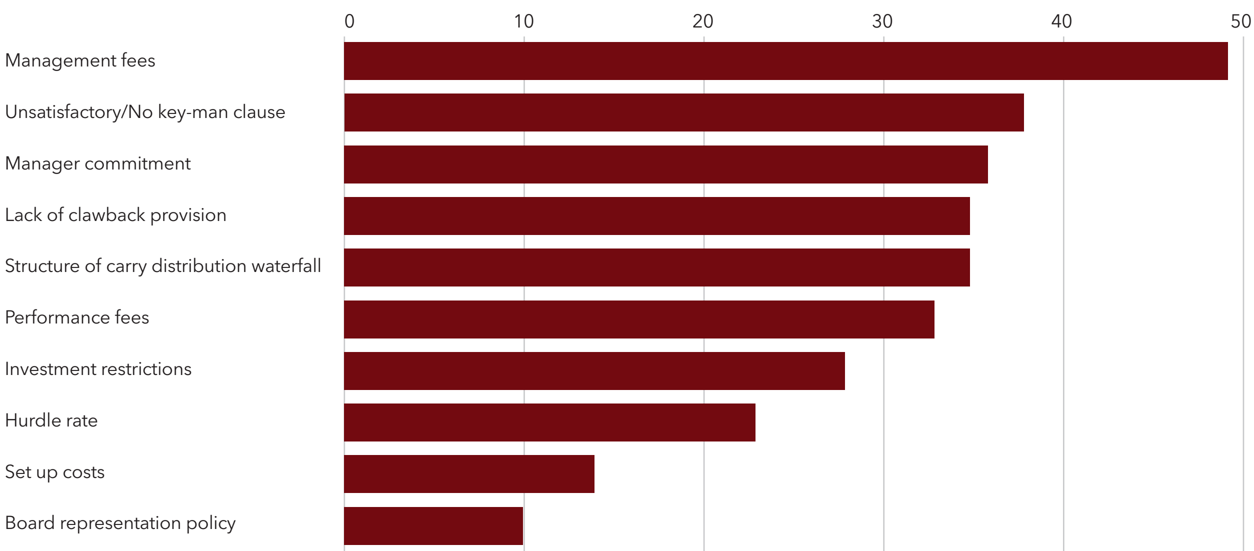
"The SEC has been examining real estate managers," says Matt Posthume, a real estate funds partner at Ropes & Gray. "A few years ago, they looked closely at fees and expenses issues. As a result, managers have a much more robust and wholesome disclosure about what exactly they can charge the fund for."

Ways to increase disclosure and transparency can include detailing the property management fee in the LPA, for example. Some investors, such as New Mexico State Investment Council and California State Teachers' Retirement System, have also increasingly hired consultants and sought external help to analyze and recalculate fees.

"My sense is that when the fees are disclosed, generally speaking investors have not had problems with it because if the investor is familiar with the real estate industry, they know that's how it works," Posthume says.

"The charging of property management fees and expenses has not changed, but the disclosure has gotten more robust. Some of the fund admin and reporting fees were fees that managers were not passing through to the funds 10 years ago, and now they are. That's become accepted." ■

Which three LPA terms cause the most disagreement with managers when conducting funding due diligence? (%)



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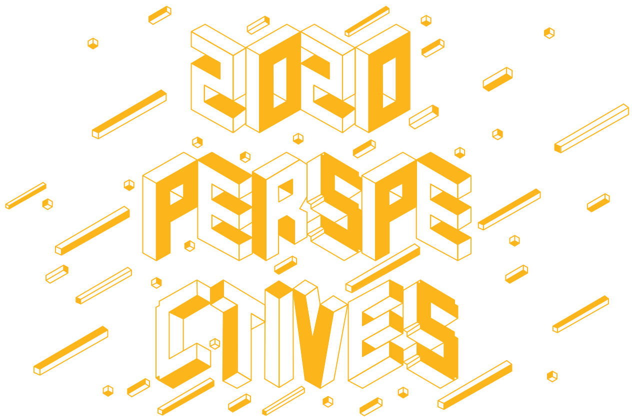


Tiptoeing around secondaries

The majority of investors surveyed by PERE have no plans to enter the secondaries market in 2020, writes Marine Cole

While investors are taking great advantage of the secondaries market to manage their portfolios of private equity fund stakes, they continue to be more tentative when it comes to secondaries on the private real estate side.

Transaction volume in the secondaries market across alternative asset classes has been growing at a fast pace – a total of $74 billion was transacted in 2018, up from $58 billion in 2017, according to data from advisory firm Greenhill & Co. This was driven mostly by buyouts and venture capital.

However, real estate secondaries activity has been more subdued: in 2019, real estate secondaries transactions totaled $6 billion, according to Greenhill.

More than half of investors polled – 52 percent – say they have no plans to either buy or sell fund stakes in the next 12 months, while 33 percent are unsure about their plans.

> *"Manager-led [secondaries] transactions are nothing new, but they are becoming more and more prominent in the real estate space"*
>
> **ANDY NICK**
> **Greenhill & CO**

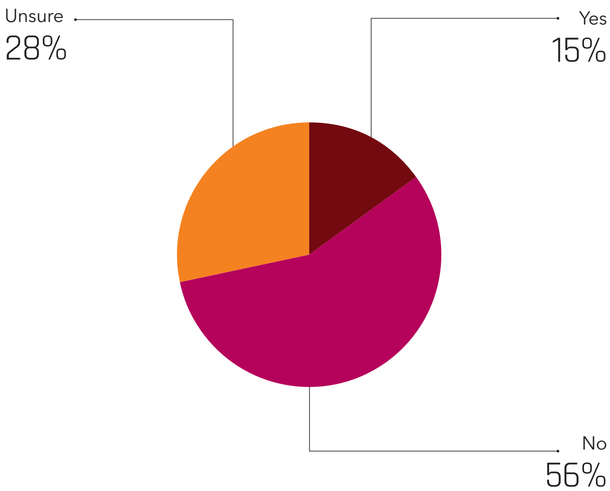
Only 7 percent plan on both selling and buying, 7 percent plan on buying only and 1 percent plan on selling only.

According to Andy Nick, managing director at Greenhill & Co: "From our perspective, transaction activity of investor sales in the real estate space has been somewhat choppy historically, given the timing of a few very large transactions that have accounted for a meaningful portion of real estate volume.

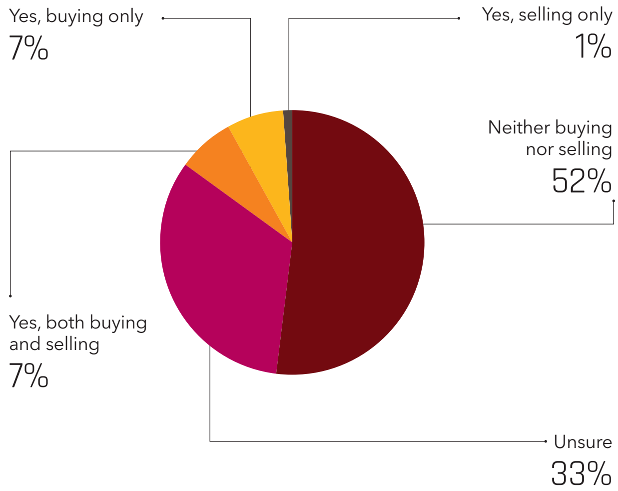
"Whereas the sale of a portfolio over $1 billion is still big in the buyout space, it's exceptionally big in the real estate space where total annual volume has never exceeded $10 billion globally."

In fact, there have not been yearly multi-billion-dollar portfolios of real estate

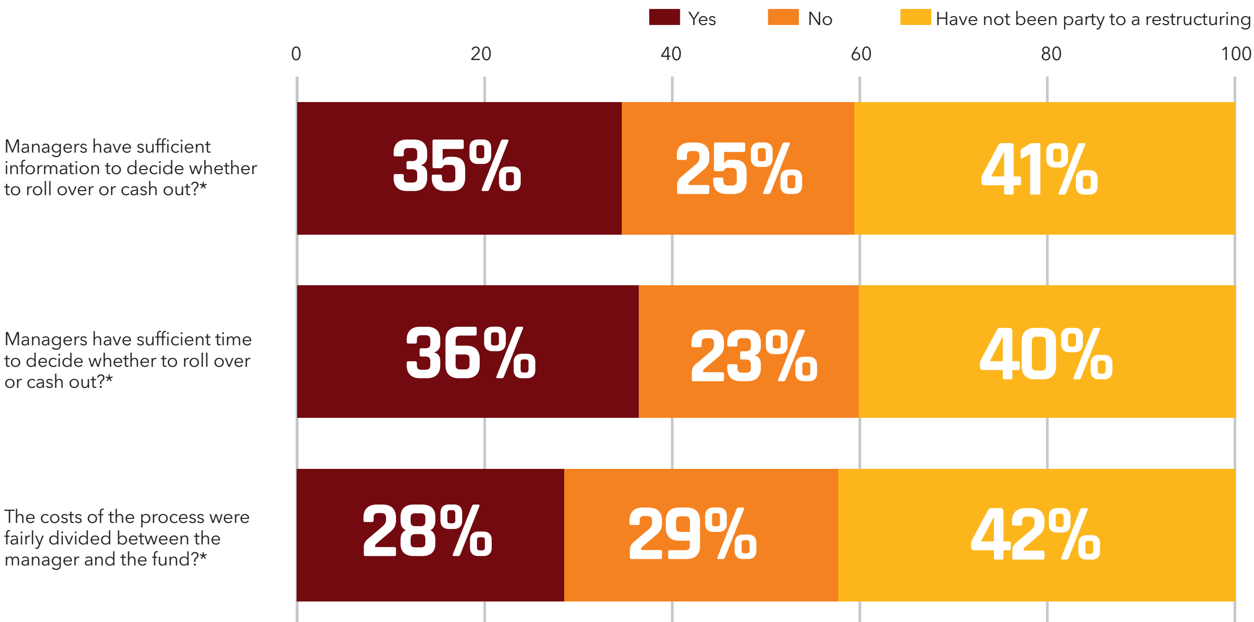
Do you plan to commit capital to secondaries funds in private real estate over the next 12 months?*



Do you plan on buying or selling fund stakes on the secondaries market in the next 12 months?*



Managers are increasingly instigating restructuring processes on old funds, to move assets into a new vehicle. In these circumstances, do you believe:



Figures may not add up to 100% due to rounding

Source for all data: PERE

fund stakes in market since the $3 billion sale from the California Public Employees' Retirement System to Blackstone's Strategic Partners in 2015.

GP-led secondaries

However, the manager side of the secondaries market is more vibrant. Manager-led deals include fund recapitalizations, restructurings and tender offers, and represented about 35 percent of total volume in 2019.

"Part of what's been driving volume is sponsor-led transactions," says Nick. "Historically, direct players were focusing on underlying properties or portfolio recaps, but that part of the market is now being capitalized in part by secondaries buyers. Manager-led [secondaries] transactions are nothing new, but they are becoming more and more prominent in the real estate space." As holding periods are getting longer across the real estate market, manager-led secondaries should continue to see strong activity. "Managers are going to want to find a way to continue to manage those assets while at the same time providing investor liquidity," says Nick, who adds that it should continue to slowly fuel growth of the overall real estate secondaries market. ■

On the minds of investors

Three private real estate investors give their thoughts on what to expect in 2020

Our panel

ANNE BREEN
Global head of investment process and strategy, real estate
Aberdeen Standard Investments

RUTGER VAN DER LUBBE
Head of global real estate strategy
APG

STEPHEN SPOOK
Senior investment officer real estate
State Investment Board of Florida

What surprised you most in 2019?

Anne Breen: The visible impact on the markets we invest in from political, climate and social change. We witnessed increased risk aversion and poor liquidity in the UK due to Brexit and bush fires in Australia impacting tenants. These types of issues are becoming more 'normal,' and may no longer be surprises in 2020 and beyond.

Rutger van der Lubbe: How great a year it was for many asset classes from a return perspective, including real estate after a weak 2018. A number of downside risks that investors had feared were in fact avoided.

Stephen Spook: I thought interest rates would surely rise. All signs seemed to point in that direction, but increasingly it seems as if we are in uncharted territory.

What investment issues keep you awake?

AB: The joint ambition of tenants and landlords to tackle carbon emissions, technological disruption, greater connectivity and the changing demands of the population is materially influencing our investment strategy. These forces mean we must ensure we are delivering the space occupiers demand and in the locations that retain long-term relevance to communities.

RvdL: The frequency and intensity of extreme weather events is becoming increasingly apparent, underscoring the importance of accelerating the decarbonization and climate change resilience of the real estate industry. That is why we are closely involved in an investor-led initiative that builds on the Carbon Risk Real Estate Monitor project.

SS: Foremost is the rich pricing environment for real estate. The state of retail certainly also has our attention, which is under pressure and evolving in response to e-commerce. I don't believe the industry has any concrete answers as to the future of retail real estate.

What are the most promising regions and strategies in 2020?

AB: For the risk-averse investor looking for long-term income, core offices in Europe and Asia could still offer some value given persistent low supply. Better absolute returns will come from selective value-add opportunities in the office space. We still see value through a lack of supply of urban logistics in key European markets. Diversifying exposure across segments less reliant on economic growth is also recommended at this point. Urban population growth combined with limited new supply means there are good opportunities in both high-quality and affordable rented residential accommodation and longer leased retirement living assets across many global cities.

RvdL: We have no strong regional bias at the moment. We also observe little dislocation between public and private markets following strong listed real estate returns in 2019, although retail remains a standout on a sector basis.

SS: The US looks the most promising. All economic indicators continue to be positive and strong. Certainly, there will be plenty of differentiation between metros and property types, but opportunities to create value are still available, although not without stiff competition. The good spreads available in certain Asian markets can create attractive income returns and the China growth story continues despite a slowdown. Europe has pockets of interest and the continued strong demand for core product by domestic investors should provide attractive opportunities for value-add strategies.

What is your one piece of advice for fund managers?

AB: The return outlook is somewhat softer, not only for core strategies, but for value-add and opportunistic funds. Against this riskier backdrop, investors should not compromise on asset quality. The residual value on long lease assets should remain front of mind. There is an ability to take risk in many markets, but this needs to focus on the true durability of demand in view of the long-term disruptive forces impacting our markets.

RvdL: Keep adhering to high standards in governance, alignment and sustainability.

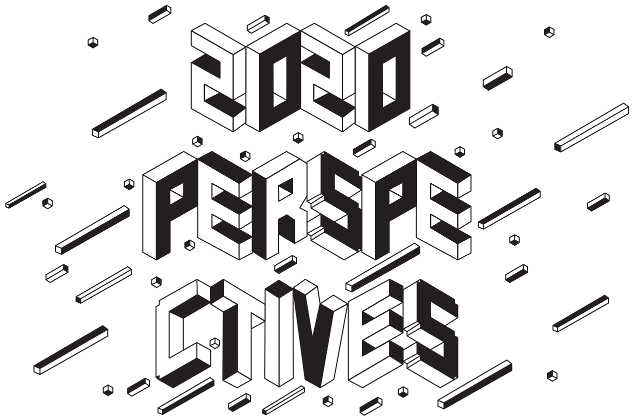
SS: Investors increasingly seek to utilize the vast amounts of data that our investments with managers offer. As we continue to enhance data analytics to make better investment decisions and control risk factors, we advise managers to work alongside investors, as good partners, as we build our capabilities to utilize this data.

What is the biggest challenge in 2020?

AB: Rewriting the rules on what drives the durability of cashflows and ultimately real estate values, as the drivers of demand are structurally changing. The critical factor is continuing to focus on high-quality relevant buildings in climate-resilient locations, thus offering our tenants the space, connectivity and flexibility they require to meet their ongoing challenges.

RvdL: Thinking longer term than just 2020, besides the obvious challenge to keep on delivering attractive risk-adjusted returns in today's environment, we see various fundamental changes within the real estate industry impacting the risk assessment of individual assets.

SS: Core pricing is of particular concern, given our 80 percent target for core real estate. It is not an option to stop investing in core. Because we are seemingly late in the cycle, we are very focused on protecting the downside, so we are seeking investments that have shorter business plans and property types that should weather a downturn better than the broader market. ■



Co-investing is a question of time and size

Interest in the strategy is slowly growing, but a lack of time and sufficient staffing often prevent investors from pursuing it, writes Marine Cole

Real estate investors are increasingly embracing co-investment opportunities, but the many that are still not following this path typically cite the same practical challenges as reasons precluding them.

More than a third – 37 percent – of investors polled for the *PERE Perspectives 2020 Survey* say they plan to participate in co-investment opportunities in the next 12 months, up from 31 percent in last year's survey. However, a greater share of investors are unsure about their co-investment activity in 2020–21 percent, compared with 16 percent in 2019.

"Co-investments continue to be opportunities that a lot of investors are interested in, often as a way of lowering their overall fees, because co-investments often have lower fees and carry," says Matt Posthume, a real estate funds partner at the global law firm Ropes & Gray.

Lower fees are not the only attraction of co-investments. It also offers investors more control over the make-up of their portfolio and can help them get to know managers better – it can facilitate, for example, a clearer understanding of the way a manager works and underwrites transactions.

The level of interest in co-investment in the private real estate asset class continues to be lower than in private equity, where 59 percent of investors polled reported they are planning to make co-investments in the next 12 months.

The hindrance factors

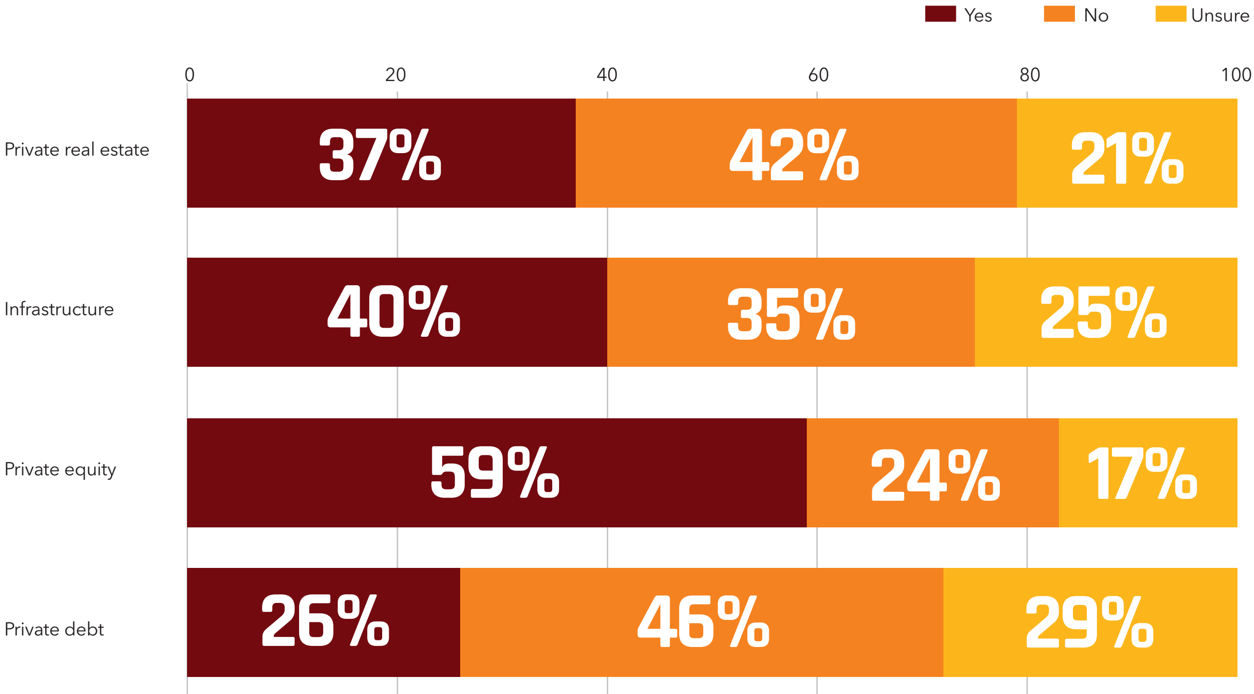
The speed required to conclude a transaction is the biggest factor cited by investor respondents for hindering their participation in co-investing.

"From the sponsor perspective, when there's a co-investment opportunity, they want to be able to move quickly," Posthume says. "They don't want to have to survey all the 30 or 40 investors in their funds to see whether they are interested in providing capital."

The second most cited factor – the fact that the investor may not be staffed adequately to participate in a co-investment – is closely linked to the first. As a result of the need for speed in co-investments, there's a natural selection that takes place and that often favors larger institutional investors.

"Most of the time, those interested in co-investments are the largest investors," says Posthume. "They have bigger staff and are more able to evaluate opportunities and act fairly quickly. The smaller shops really don't. They may have just one real estate

Do you plan to participate in co-investment opportunities over the next 12 months?



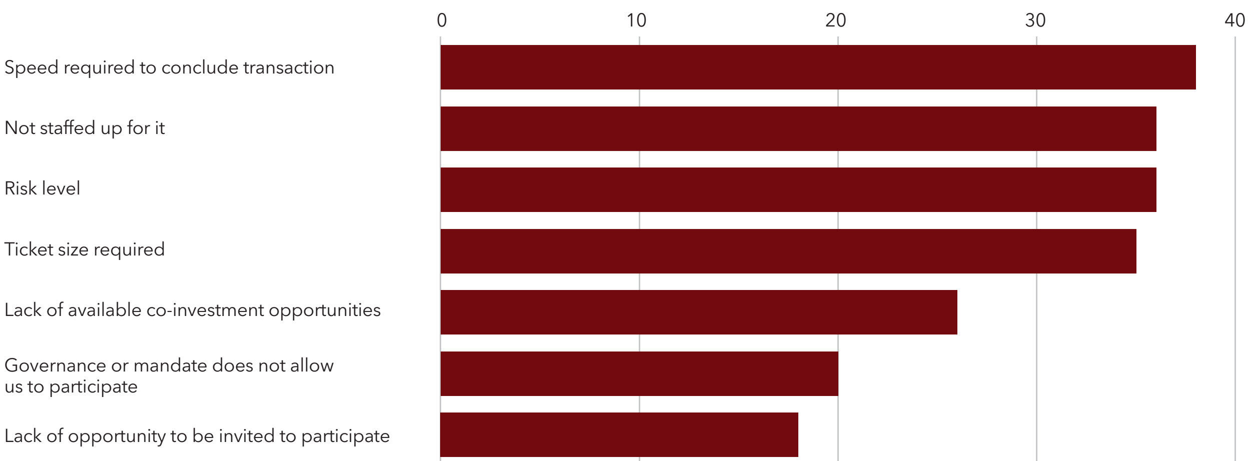
Figures may not add up to 100% due to rounding

person. It's harder for small investors to really evaluate co-investments in the time that's needed."

Co-investments can also lead to greater concentrations of capital in an investor's portfolio. Nevertheless, some large pension plans including the California State Teachers' Retirement System, which has $254 billion in assets under management, and the Teacher Retirement System of Texas, which has $153 billion in assets under management, have used co-investments over the past year to increase their exposure to real estate. To circumvent the practical hurdles, some pension plans interested in co-investments have made formal co-investment commitments to funds which are not binding, but which speed up the process once an opportunity arises.

"The reason they want to do that, is it takes away at least one layer of approvals internally," says Posthume. "Now they don't have to go to their investment committee to approve that deal." ■

Which factors hinder your participation in co-investing opportunities? Multiple responses accepted (%)



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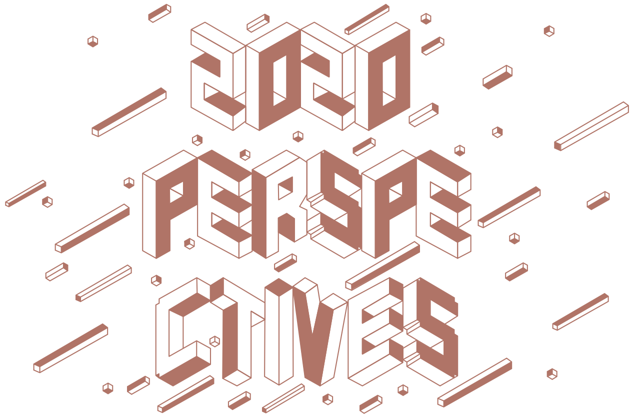


ESG and diversity not yet center stage

Although both issues are increasingly industry talking points, they are a priority for only a few investors, and lack of gender balance is rarely a deal-breaker

The recent Australian bush fires are a reminder, if one were needed, of the impact of the climate crisis and on the urgency for the real estate sector to push forward with meeting net-zero carbon targets and resiliency initiatives. Nor can the sector avoid coming under the microscope on diversity. So, it is not surprising that it feels as if every private fund manager is eager to boast of these issues being part of its DNA. But *PERE*'s *Investor Perspectives 2020 Survey* reveals that a minority of institutions consider environmental, social and governance issues or diversity as central concerns when deciding on investment opportunities.

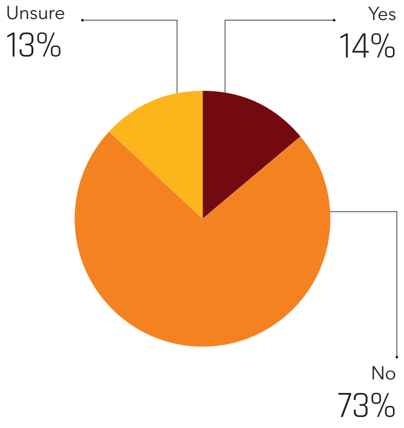
Just 31 percent of investors polled say an analysis of a manager's ESG credentials represents a major part of their due diligence process. Half say it forms only a minor part of the process, while 19 percent do not include any examination of ESG practices at all. Part of the problem may be that it can still be challenging to measure ESG outcomes and correlate them to actual investment returns. And it can be particularly hard to quantify any increase in an asset's value from health and wellbeing initiatives, which have taken something of a starring role in the conversation of late.

"I don't think it is entirely correct to argue that lack of measurability restricts ESG due diligence," says Kiran Patel, chief investment officer at Savills Investment Management. "There are more third-party providers of benchmarking services than ever before. What is more difficult is finding consistency and comparability with pricing impact."

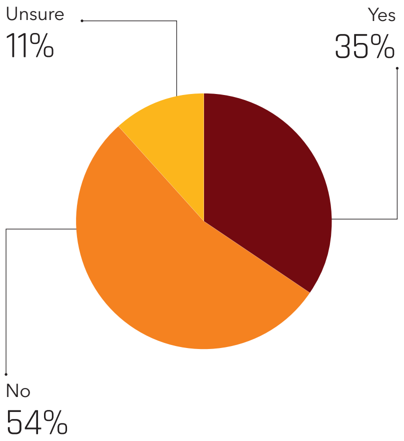
Patel is optimistic the issue is here to stay. "ESG considerations are only going to become more important, with both top-down pressure and bottom-up factors such as energy efficiency. I wouldn't say this is a priority

> *"ESG considerations are only going to become more important, with both top-down pressure and bottom-up factors such as energy efficiency"*
>
> **KIRAN PATEL**
> **Savills Investment Management**

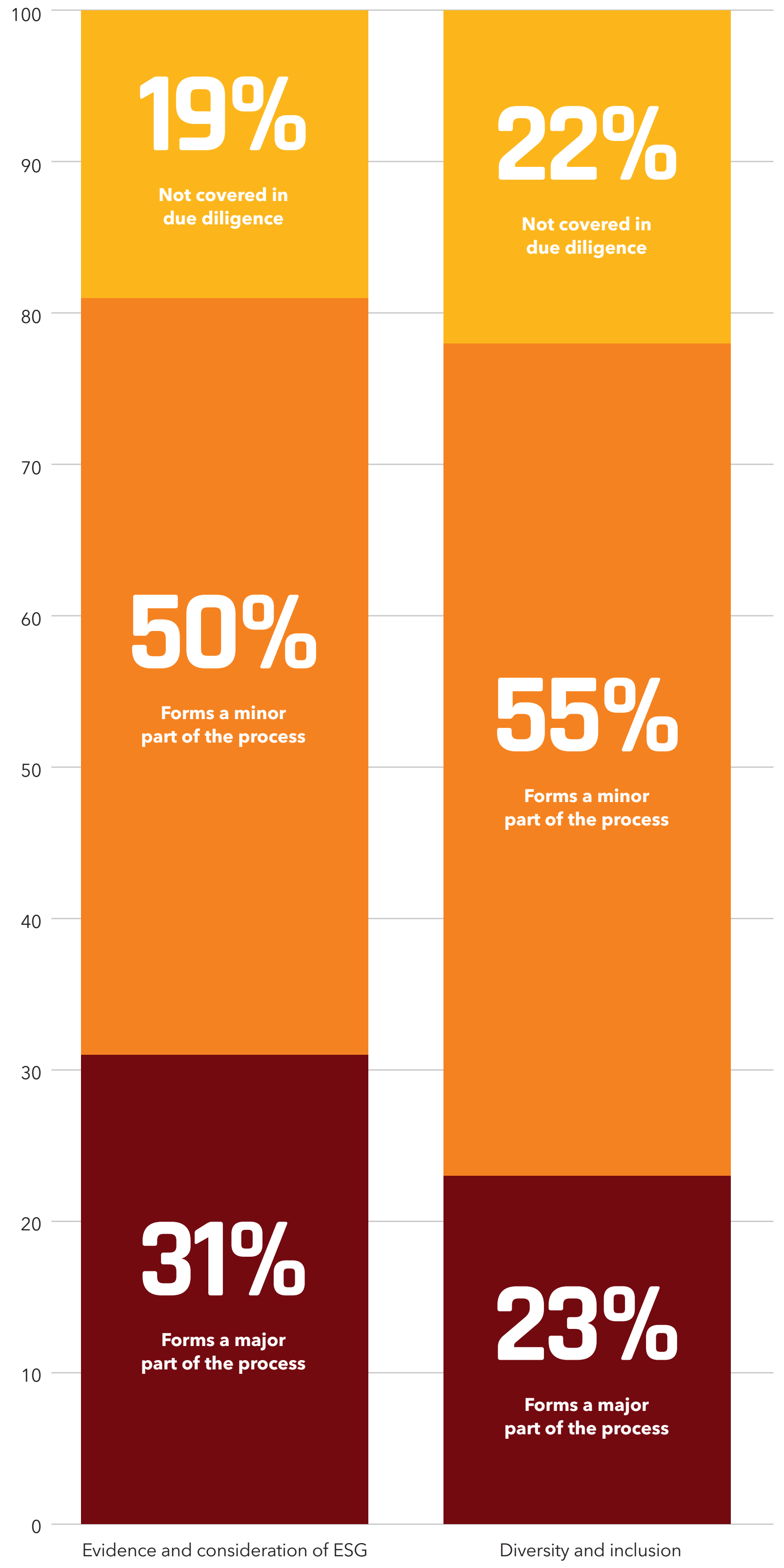
Has your institution ever refused an opportunity based on a lack of diversity and inclusion at the fund manager level?



Do you actively engage your fund managers to promote gender diversity and inclusion?



ESG and diversity are typically secondary factors in due diligence



Source for all data: PERE

for all investors, but it is increasingly important for many."

Diversity dilemma

Diversity forms a major part of due diligence for only 23 percent of investors. Further, 73 percent have not refused an opportunity based on a lack of diversity at the manager level and 54 percent are not actively engaging managers to promote these issues. But this too is an issue unlikely to go be going away any time soon. "It will not disappear," says Andrea Carpenter of Women Talk Real Estate. "It is being taken seriously by industry leaders who know that while there is still much work to be done, a responsible and successful business is not possible without it."

"Diversity matters a lot," says Patel. "We are asking our recruiters to work toward presenting us with more female candidates so we can improve diversity and still pick the best person for the job. We don't want quotas. But these processes take time." ■

Points of view

Quick-fire insights on the private real estate investment markets

"To date there has been a tendency to stick with current managers – that is certainly the case for the investors we've been talking to"

Kiran Patel, chief investment officer, Savills Investment Management

"Investors want to do more with fewer managers and concentrate relationships wherever possible. The exception would be when investing in niche sectors [like] data centers, where they need to look further afield [for] expertise"

Alfredo Lobo, partner, Hodes Weill

"Investors rightly regard real estate as a good diversifier and return enhancer"

Alex Jeffrey, global chief executive, Savills Investment Management

"Given there is little or no yield compression in most sectors, the main ways of seeking to achieve higher returns are value-add and opportunistic strategies"

Steven Cowins, Greenberg Traurig

"Fiscal policy, climate change and technology and infrastructure systems [are] set to have an increased impact on the commercial real estate markets and how investors allocate capital in 2020 and beyond"

Megan Walters, global head of research, Allianz Real Estate

"We all know that retail is under pressure and evolving in response to e-commerce. However, I don't believe any of us in the industry have any concrete answers as to the future of retail real estate"

Stephen Spook, senior investment officer, real estate, State Investment Board of Florida