Emerging Trends in Real Estate®

The global outlook for 2014
By common consensus in the three Emerging Trends reports, intense competition for prime real estate is forcing investors to move up the risk curve in the US, Europe and Asia Pacific.

Here we interview respected property players from each region to get further insight into their respective territories and an indication of how that shift up the risk curve differs from market to market.

The view from the US

How is Heitman performing in its core markets and what is the outlook for the rest of the year?

“In the US, conditions continue to improve along with the economy. Early-recovery sectors like apartments (rented residential) have shifted into a more mature phase marked by a slower rate of net operating income growth. Office and industrial will see strong income growth as occupier demand accelerates while construction is at cyclical lows. In Europe, the economic recovery should begin to release pent-up space demand after a period of stagnation in demand and rents. And investment capital will begin migrating to riskier assets and markets. Asia is more variable. Tokyo office is poised for rent growth as the nation’s economy accelerates. Australia’s property markets have weakened but investment demand has not.”

What is driving performance in your chosen markets – is occupier demand feeding through to rental growth or is weight of capital and yield compression the key influence?

“In the aftermath of the global financial crisis, capital flows were anticipatory: investors snatched up prime assets in prime markets at bargain prices but well ahead of the property market recovery. Over time, the weight of capital caused significant yield compression. Now, yields have compressed about as far as they will in these liquid markets. Investment performance in these locations is now about what happens to rents and occupancy.”
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Attitudes to risk across the world

Yields have compressed about as far as they will in liquid markets. Investment performance in these locations is now about what happens to rents and occupancy.

How does Heitman’s approach to investment risk differ at home in the US and overseas, if at all?

“We approach investment risk the same way across the three regions in which we invest. Ours is a research-led investment process, with investment strategies designed to capitalise on mispriced risk and emerging opportunities. We use multiple types of diversification to mitigate risk, including diversification by property type and by market type, with the latter focused on managing a portfolio’s exposure to various types of economies. Finally, we like to mix together investments in primary markets with those in liquid secondary markets where the potential for yield compression exists. And we have embraced specialty real estate sectors for their above-average yields and less-cyclical demand.”

Do you subscribe to the theory that competition for core assets is sending many investors up the risk curve (and into secondary assets or prime assets in secondary cities, or development)? Is Heitman adopting such a strategy?

“The move up the risk spectrum is a function both of yield compression and of the cycle. The sharp shock of 2008/09 pushed most investors into safe mode. Our investment strategy has been widespread from the early days of this recovery, mixing up prime assets in prime markets with prime assets in secondary markets to achieve yields/total return premia that exceeded the additional risk. We are particularly willing to go to smaller markets for retail centres with national tenants. We are developing in locations where we have first-mover advantage. And we like renovation strategies – core with a scratch – or assets previously owned by a capital-constrained entity where occupancy and rents can be improved with a coat of paint or upgraded amenities.”

Heitman has made notable moves recently into the UK healthcare sector with Signature Senior Lifestyle and into the German residential market with Grainger. Can you explain the rationale behind such diversification and the partnership approach here?

“You’ve hit it. Our investment in specialty property types is partially about diversification. We like adding specialty properties into a portfolio because their occupier demand is often delinked from the macro economy. Senior housing demand, for instance, is typically triggered by need. As a result, these sectors hold up well during recessions as well as periods of economic growth, boosting portfolio returns. We make specialty investments in partnership with operating companies that have deep experience in managing senior housing or self-storage or student accommodations. Their expertise they bring is critical to investment success. Our rationale for the investment with Grainger related to favourable supply/demand characteristics in a developed country where rental housing dominates over for-sale housing. While the eurozone recession has translated into flat rents for most property types, rented-residential rents have been growing.”
The view from Europe

Ongoing competition for core investment properties in Germany is concentrating attention among your peers on riskier and thus higher yielding investments. There is also a greater trend towards investing in development projects. How has Union Investment’s appetite for greater risk manifested itself?

“Project acquisitions accounted for about half of our own investment volume of some €4.5 billion in the last two years. We expect development projects and redevelopments to play a greater role for investors going forward.”

What effect have equity-rich investors such as sovereign wealth funds had on your markets?

“If investors from Asia and the Middle East were to significantly boost their positions in European real estate markets, competition will become even more intense. European investors will be under even more pressure to adopt alternative investment strategies.”

What is your position on alternative asset classes, such as student housing, senior living and healthcare, as another route up the risk curve?

“We don’t go for alternative asset classes like the ones you mention. But we have launched a special fund for renewable energy – windparks and photovoltaics – last year.”

How do you think mainstream European investors balance safety and returns in the current economic climate?

“The euro crisis is having a more sustained impact on investment decisions than expected. Investors remain cautious in terms of strategy and are taking precautions against defaults. At the moment, though, the only way to generate higher returns is to take calculated risks.”

Does Union Investment’s approach to investment risk change from country to country within Europe and change again in markets further afield?

“Our strategy is mainly the same for all markets we act in – core and core with slight ‘scratches’.”

What is the investment strategy for Union Investment going forward?

“Our focus will remain on the ‘ripe’ national and international real estate markets in Europe, the Americas and Asia Pacific. Besides this we will put a stronger investment focus on so-called secondary cities. In Europe that would include Birmingham, Cardiff, Darmstadt, Bremen and Nuremberg. In the US it would be cities such as Austin, Texas.”
The view from Asia

Real estate markets across Asia were for the most part very strong in 2013 with investment activity rising throughout the year. How do you see the markets performing during 2014?

“The markets have remained very strong and that’s partly driven by increased allocations to real estate by many institutions and funds and then, in turn, greater allocations to the Asia Pacific region. So we’ve got an even greater weight of capital trying to find a home. Asia, of course, is a series of markets within a market and there are some stronger contenders than others. Japan continues to be the flavour of the month and China continues to attract a lot of attention despite some slowing in the economy. In terms of the more emerging property markets, Indonesia, the Philippines and Vietnam are all attracting attention.”

Competition for core assets is sending many investors up the risk curve. How is that trend developing in Asia Pacific?

“A lot of it is driven by diversification into real estate and then diversification across the sectors. In trying to find a home for their wealth, investors are having to look at second and third tier cities because they can’t find product in the capital and major cities in the region. They’re also having to move back into the development arena. Many of them moved away from development risk after ’08 but they can’t find the quality product now and the reality is that if they are going to be major players, they have at least to assume some construction and market risk if they are going to participate in potential opportunities.

“People have short memories. They are now rationalising risk in a way that a year or two ago they would have said, ‘this is not for us – too risky’. They are definitely moving up the risk curve.

“What’s interesting, I think, is the move into non-traditional areas of real estate. You’ve got the shift into second and third tier cities but you’ve also got the shift into logistics, student housing and retirement homes. Not that it’s their core business but developers are now spreading their horizons much wider in terms of the sectors and businesses that they look at.”

What is driving performance in the main markets? Is occupier demand feeding through to rental growth or is weight of capital and yield compression still the key influence?

“All the economies in the region are doing reasonably well. There is some slowing because many of our economies depend on exports but four, five and six percent is being achieved in many of the economies, which is obviously very good by European standards. And if you’re looking at that sort of GDP growth then businesses are growing, there is increased employment and increased occupational demand for real estate. In Asia, too, there is a major issue around housing. Nearly all of our markets have challenges in that the latent demand is huge. For anyone who wants to own their own home, there are issues around affordability. So, one of the sectors attracting a lot of attention today is residential.”
Asian sovereign wealth funds and institutional capital have been a major force across the region in 2013. Do you see that influence continuing in Asia Pacific this year and beyond?

“Governments are looking to these funds to play a major part in city agendas and in urbanisation and regeneration across the region. They are seen as the private partner in the public-private relationships which will have to be developed to drive many of the urbanisation and regeneration programmes in Asia Pacific.”

Are there any indications that Asian funds and institutions adopt a different approach to investment risk between different markets of Asia Pacific, or further afield in Europe?

“They are looking to the US and Europe to spread their risk. Clearly in most of our markets there is a much higher element of risk than you’d find in a mature market and they are working hard to secure that balance. But they are more comfortable with Asia than a US or European investor. So the regional and country risk factor that others might weigh quite heavily when reviewing opportunities in Asia, they look at it through a different set of spectacles, if you like. With development, I think they would look at it in a similar way across all markets. It’s the way they look at the country risk and the regional risk that’s different.

“It is also fair to say that local funds and investors have more of a trading mentality than an investment mentality. They’re not speculators but their horizons are usually five to 10 years. The discussion on any investment on which I advise is invariably centred around exit – what is our exit strategy?”

Any clouds on the horizon, such as the onset of “tapering” by the US Federal Reserve and the threat of interest rate rises, or a slowdown in China’s economy?

“Certainly borrowing money has become more expensive. We have also seen the more troubling signs of grey lending with funds set up in mainland China outside the banking regime – up to half of the funding into real estate last year came from the grey community. But reforms in China are impacting on the economy in a positive sense in that the focus is much more on sustainable growth rather than growth for growth’s sake.

“An aspect of every real estate discussion is the impact of tapering but my experience is that whilst a lot of the money linked to financial initiatives in the US went into the stock markets and, to a certain extent, property speculation, not a lot of it has gone into the purchase of core assets.”
If investors are going to be major players in Asia Pacific they have at least to assume some construction and market risk.