



Unlocking real estate opportunities

Q&A with Paul Guest, senior portfolio manager with
UBS Asset Management, Real Estate & Private Markets

Why is private markets investing particularly now so attractive?

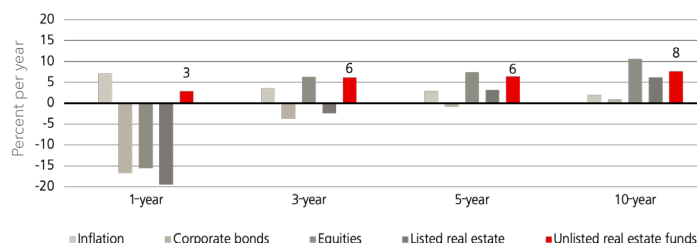
Private markets offer diversification, lower volatility, and exposure to market structures that positively impact the risk-return equation. In today's environment, investors face the challenge of optimising portfolio allocations for appreciation potential and income generation, while mitigating volatility and broader issues such as climate change. While institutional investors have long embraced private markets allocations, these opportunities are becoming increasingly appealing for noninstitutional investors, as well, due to their potential for higher return, lower correlation with public equity markets, inflation protection, and access to otherwise inaccessible markets and strategies.

Private markets provide the ability to trade liquidity for higher returns at comparable risk levels, while granting investors greater asset control and the opportunity to benefit from skill and illiquidity premiums. In addition, private markets serve as a gateway to sustainable investments in high-growth sectors, aligning with the increasing focus on sustainability for many investors. Sustainability is a complex and rapidly evolving field, however, with challenges such as increasing regulations, stakeholders' transparency expectations and the lack of standardisation in reporting and scoring. The private markets industry knows these challenges and our approach to face them focuses on expanding the diversity and scale of our activities.

Why invest in real estate over the next few years? Where do challenges and opportunities lie?

Unlisted real estate sits between bonds and equities in terms of its risk-return characteristics. Historically, it has offered higher returns than bonds but lower risk than equities and listed real estate. Real estate also has a low correlation with bonds, while at the same time delivering higher returns with only slightly higher volatility. As such, it is often used as a portfolio diversifier. The favourable

Figure 1: Unlisted real estate also provides stable returns and can be considered as good inflation protection (4Q 2022, percent per year)



Notes: Inflation = Advanced Economies; global corporate bonds = Bank of America Merrill Lynch Global Broad Corporate (USD, data only available from 1997); global equities = MSCI World Index (local currency); global listed real estate = FTSE EPRA Nareit Developed Europe; global unlisted real estate funds = ANREV / INREV / NCREIF Global Real Estate Fund Index (GREFI) core funds with performance pre-2005 estimated by UBS (local currency). Past / expected performance is no guarantee for future results. Sources: MSCI; Oxford Economics; NCREIF; Refinitiv Datastream; UBS, Real Estate & Private Markets (REPM), May 2023

risk-adjusted performance is the result of the high proportion of the total return, which is derived from the contractual rents paid by tenants – the income return. Over the long term, core real estate – the lowest risk profile form of real estate investment – is expected to deliver the majority of its total return from income (70 percent to 80 percent), with the remainder coming from capital growth.

Real estate is holding up relatively well, with 2022 witnessing the second-highest global deal volume at approximately €1 trillion¹, and we see both short- and long-term benefits for those who explore this asset class. The current repricing, distressed investment opportunities and fresh equity providing a considerable negotiating power all add to the short-term benefits. We think now is an opportune timing to consider investments for several reasons.

Firstly, the recent adjustments in prices due to higher interest rates have created an attractive entry point. Such opportunities arise only once in a cycle, making it a unique chance to capitalise on favourable market conditions.

Secondly, investing in quality real estate with a promising outlook, especially when its value has adapted to the prevailing higher discount rate environment, can yield significant future returns. Therefore, taking advantage of this opportune time to invest in real estate is likely to prove highly advantageous, as it aligns with the potential for growth and improved returns in the future.

It is also important to note that real estate is a less liquid asset class compared with the daily traded public markets in equities, and investors need to take this into consideration. In downturns, it may not be possible to sell real estate investments or sell only at a significant discount. As such, real estate investors typically have long-term investment horizons and do not require the high levels of liquidity provided by public markets.

What benefits can private markets, particularly real estate, bring to a portfolio?

There are many benefits investors can be excited about when choosing real estate. Firstly, diversification, which is key to achieving stable performance. We find low correlations between real estate and bonds and equities. This means adding real estate to a portfolio can improve the risk-return balance and enable investors to achieve desired returns with reduced risk. Second, real estate provides income through rents paid by occupants leasing properties. Third, real estate presents the potential for capital appreciation, including through active asset management.

Finally, real estate can serve as a protection against inflation, as rental income typically grows in line with inflation – moreover, in an actively managed and unique portfolio that would be impossible to replicate in the open market. Our privileged position as a leading provider of unlisted real estate solutions means investors can benefit from our scale and network to unlock investment opportunities that are typically only available to institutional investors.

How do you think property values will develop across key real estate markets?

The private equity real estate market is, like other asset classes, adjusting to the higher interest-rate environment. This has necessitated a valuation adjustment, as the discount rate on future cashflows has shown strong growth. This is offset at least in some sectors, however, by particularly robust tenant markets and, therefore, stable, high occupancy rates and healthy rental growth. As a result, although the loss in capital value has temporarily exceeded the stable income return, this opens a window of opportunity to acquire good-quality assets. As interest rates stabilise, the negative pressure on values will ease, and income returns will once again start to dominate.

Of course, this will not happen at the same pace across sectors and geographies, and tenant demand is not as robust in all places and all times. This underlines the importance of expertise and an actively managed portfolio, so investors are able to take advantage of timing and seize the opportunity where asset values will rebound soonest and most strongly. We work closely with our in-house Research & Strategy team to anticipate market movements and position portfolios ahead of the movement in asset values.

We are looking for real estate markets broadly to stabilise in the second half of this year, with leading sectors such as logistics, living assets and life sciences/healthcare to provide the most compelling rebound.

How do you pool likeminded investors and ensure alignment of interest with investment managers?

We have the ability to negotiate enhanced investment conditions via pooling similar investments rather than investing solely on an individual fund basis. This is the case with investments into existing funds, or when we act as cornerstone investors in newly launched funds. We are regularly able to negotiate the best terms for all our clients.

Examples of the benefits of pooled investments include but are not limited to: reduced fee loads for both primary and bespoke investments; enhanced transparency and removal of unfavourable terms, executed via our strong side-letter negotiation; or verifiable sustainability impacts. We are able to share best practices amongst managers and general partners, in addition to obtaining further information from them.

How do private markets play into the trend of semi-liquid solutions?

There has been increasing interest in private markets from a wide range of investors. Historically, because of scale, access and information asymmetries, private market assets were typically only available to institutional investors, and while these investors have steadily increased their exposure to private market assets during the past two decades and are projected to continue doing so, liquidity and other structural and regulatory constraints still limited access to these products for a wider range of investors. This is changing.

Improvements in transparency and the availability of data has led regulators, within certain important limits, to define investment structures, giving noninstitutional investors access to private market assets. The characteristics of these asset types, in particular their relative illiquidity, need to be properly understood by investors. But with that in mind, the semi-liquid solutions now

proposed do bring all the portfolio benefits of an institutional asset class to a much wider universe of investors.

What is your view on integrating sustainability factors into real estate solutions?

Sustainability is something we can no longer ignore, and if we look at what is happening to our planet, it is not difficult to understand that this topic has become urgent. The link between climate change and real estate is stronger than we might think. Indeed, as natural disasters increase, so do the physical risks faced by our buildings, which results in growing premiums. That's why integrating risk analysis is a crucial component to assess the possible financial risks of our assets, and it is an embedded practice into our transaction and monitoring processes.

Although estimates might differ, the real estate industry accounts for approximately 39 percent of total emissions.² This means that we, as real estate proprietors and investors, have a significant responsibility to ensure that our assets are managed in accordance with science-based net-zero goals. It is also our belief that integrating sustainability into our whole investment process improves performance and adds benefits to the whole business.

Green real estate assets generally exhibit higher value because of factors such as shorter vacancy periods, lower obsolescence, decreased depreciation, reduced operating costs, shorter tenant agreements and improved tenant retention – which is not the same for brown assets or assets that do not take sustainability into account.

Investors are on the same page, as they are increasingly asking for accountability and transparency when it comes to sustainable investments.

Notes: ¹ McKinsey Global Private Markets Review 2023, McKinsey & Co, March 2023; ² World Green Building Council, <https://worldgbc.org/advancing-net-zero/embodied-carbon/>, May 2023

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UBS Asset Management

UBS Asset Management's Real Estate & Private Markets business actively manages investments of around \$111 billion (€103 billion) globally and regionally within Asia Pacific, Europe and the United States, making it one of the largest asset managers in real assets worldwide. Our capabilities reach across the risk/return spectrum, ranging from core to value-added and opportunistic strategies. We offer both direct real estate, infrastructure equity and debt, and food and agriculture investments, as well as indirect exposure to leading real estate, infrastructure, private equity and private credit managers. Investors can access our diverse product range across open- and closed-end private funds, investment trusts, listed funds, REITs, and bespoke separately managed accounts. (Data as of 30 December 2022, unless otherwise stated.)

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