UBS Asset Management

Alternative options

Some niche real estate subsectors continue to scramble for attention and capital, while others are now becoming established investment options. Which alternative sectors should investors be looking at and which are more hype than substance?

From niche to norm: The substance in real estate subsectors

2023 was a year of prolonged high inflation, sharp interest-rate hikes and a weak economy, with looming fears of recession. Most countries, however, proved resilient and avoided recession. Now, as markets can see disinflation and signs of interest rates at their peak, there may be light at the end of the tunnel and a path to improved market conditions in 2024.

Although we think the bulk of the correction had occurred by the end of 2023, we expect capital values to bottom out in 2024. Of course, not all markets, geographies or sectors in real estate are equal. In addition to the continued challenges from geopolitical tensions, the world is changing, shaped by megatrends such as the post-pandemic "future of work" impact on office space, ageing population, focus on sustainability and digitalisation. Assessing these dominant themes is key to finding specialist investments in niche subsectors of real estate that will drive returns and have the potential to become established in the long term.

The impact of government sustainability incentives on office space

Offices that lack sustainable features and suffer from weak demand can avoid obsolescence by being refurbished into modern offices or repurposed to other uses, such as residential. In the United States, the Biden-Harris administration is supporting conversion of high-vacancy commercial buildings to residential with the aim of creating affordable, energy-efficient housing near transit and good jobs. In 2023, the White House released the *Commercial to Residential Conversions* guidebook on the federal resources available, covering 20 federal programmes to support conversions, including low-interest loans and tax incentives.

Retrofitting can be seen as the preferred, less carbon-intensive solution, however. In 2023, the Singapore government launched the S$63 million (€43 million) Green Mark Incentive Scheme to fund retrofitting projects based on their expected emissions reduction. In the United Kingdom, the Minimum Energy Efficiency Standards regulation requires landlords of commercial properties to have a minimum Energy Performance Certificate (EPC) rating of E (B in 2030), to avoid a penalty of up to £150,000 (€174,330). And in the United States, the Inflation Reduction Act 2022 provides tax incentives, such as the commercial buildings energy-efficiency tax deduction, which enables building owners to claim a tax deduction for installing qualifying systems.

Overall, we expect more schemes to be launched across countries and niche opportunities to emerge in this area. Affordable housing, particularly in cities in most advanced economies, is in short supply. Combined with sustainability incentives, this presents an investment opportunity, as governments look to partner with institutional investors to help deliver affordable housing at scale for their populations to improve living conditions and social welfare. Affordable housing also gives investors an opportunity to take part in socially beneficial investments.

Green real estate assets have moved from a subsector of real estate investing to become more established, as data and demand have grown. Our recent research[1] finds clear evidence of a green premium in the two largest office building markets, New York and London. We examined 1,453 office-building transactions in New York and London between 2010 and 2022, running a regression to analyse the economic implications of environmentally certified commercial real estate while controlling for a wide range of factors. On a price-per-square-foot basis, New York and London see material green premiums of 28 percent and 19 percent, respectively, all else being equal (i.e. location, age, renovation, occupancy and lease length). Green assets, not specifically office space, 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.

The life sciences real estate sector: High demand and demographics

With an ageing population and the post-pandemic need for further medical research, the demand for properties specifically designed and built for companies within the life sciences industry is increasing in Europe, which is behind the United States. Life sciences companies need high-specification facilities that meet their unique needs. Some of those requirements relate to aspects such as the number of air changes per hour within a laboratory, the mechanical engineering that goes in to support these types of features, the vibration criteria of the floors – considerations not typical for an office building. They can vary by different user types, whether the tenant is focused on biology, chemistry or technology, and they require significant investment. The role of the real estate sector to provide these more specialised facilities is becoming ever more important. With life sciences, particularly in the United Kingdom and Europe, many of the facilities do not yet exist today, and so there is a very strong level of demand but very little supply. That supply/demand imbalance is supportive of rental growth in the sector, while the prospect of rental growth is not as strong in the traditional sectors. Particularly when cap rates and exit yields are more challenging, gaining return through income growth is attractive for real estate investors. Equally, sustainability themes are important for investors, and the life sciences sector can meet many of those expectations, both on the social and environmental sides.

In the United Kingdom, there is the Golden Triangle of Cambridge, Oxford and London, which is internationally recognised because of the strength of the universities, the research and development work, and the hospitals. This area has taken the lion's share of life sciences investment that comes into the United Kingdom. A theme we will likely see during the next few years is that other UK areas will continue to develop into areas of excellence. We see it is already happening in many areas in the north of England and Scotland. While that trend will continue to play out, the Golden Triangle will likely retain its majority share due to the depth of the market and its connectivity into Europe and the United States.

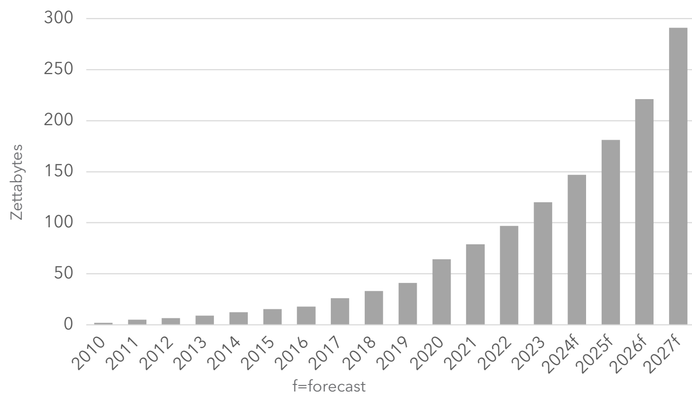
In the European Union, because of the number of countries and competing clusters, it is harder to pick a cluster because the market is in an earlier stage. We see a huge amount of potential across the Netherlands, Germany, France, Switzerland and Belgium. The three key elements that make up a successful cluster are the academic environment, hospitals and pharmaceutical companies. Those have traditionally been spoken about as the key drivers of a successful cluster. But people recognise skilled workforce availability as another key driver. That has traditionally overlapped with where large pharmaceutical firms have had a presence. On the manufacturing side, space, infrastructure, logistics and servicing need to be accounted for.

Digitalisation: The promise of artificial intelligence

Artificial intelligence (AI) has many applications in real estate investing because a single investment can generate almost limitless amounts of data. Programmes can "read" existing documents, such as leases, store key variables and flag important terms. AI can help tie disparate data sources together, such as underwriting metrics, people flow, amenity usage, revenue, utilities, sustainability, mechanicals' health and repair-work orders. Firms with large data sets could use AI to create customised benchmarks. Many national asset management teams use AI in analysing rental rate data to predict optimal unit pricing using real-time data and inputs. Future possible applications include real-time tenant credit analysis, market data trends, adaptation of floorplates and amenity spaces to tenant demand, prediction of environmental transition risk, adding alternative data to traditional underwriting (examples: mobile data, package flows, market-based amenity demand), and automated valuation models.

Better data analysis will likely emerge from the current hype around AI and drive growth in a subsector of real estate investing. The demand for digital connectivity throughout the world is well established but not yet met, as a digital divide still exists in most countries, as well as a demand for more sector-specific real estate, such as data centres to accommodate innovation. For example, the annual datasphere, which measures the amount of new data created globally, is expected to double as soon as 2027 and indicates strong growth in demand for data centres ahead (see chart below).

Annual size of global datasphere (zettabytes)



Sources: IDC; UBS Asset Management, Real Estate & Private Markets (REPM), January 2024

Historically, niche sectors have played a key role in the development of real estate markets and look set to do so again. For example, at the turn of the millennium, industrial property was relatively niche and, according to MSCI data, accounted for just 11 percent of the global market by value. By contrast, in 2022, its share had risen to 25 percent, and the property type had become mainstream. We think property types such as lab space, data centres and some specialist types of residential and living real estate, as addressed in this article, all have the potential to follow in industrial's footsteps and become important and significant parts of the global real estate market.

Note: [1] Green Premium, Study of New York and London real estate, UBS Asset Management, Real Estate & Private Markets, November 2023; https://www.ubs.com/global/en/assetmanagement/insights/asset-class-perspectives/private-markets/articles/green-premium.html

CONTRIBUTOR

Fergus Hicks

Real Estate Strategist

UBS Asset Management, Real Estate & Private Markets

For more information, please contact:

Pat O'Sullivan
Head, Investment Specialists
+1 212-821-6093 | patrick.osullivan@ubs.com
www.ubs.com/am-privatemarkets

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(Data as of 30 September 2023, unless otherwise stated.)