

Top 10 with...

Interview with **Eric Byrne on Multi-Managers Real Estate**

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MMRE facts

2007

business established¹

~USD

19.4bn

in equity^{1, 2}

70+

countries spanning
investor base¹

Invested in

120+

underlying funds
and co-investments¹



Eric Byrne, Head of Multi-Managers

A broad investment universe

The multi-manager real estate industry has boomed in recent years with many investors looking for new structures to gain and increase their exposure to real estate. Eric Byrne explains how the Multi-Managers Real Estate (MMRE) business navigates market changes to provide superior access to investments with attractive fee savings to clients.

1

In a low-yield market with increasing volatility, what benefits does core real estate offer in a multi-asset portfolio?

Real estate will remain an attractive addition to a multi-asset portfolio thanks to its relatively high yield and comparative stability. The lowered volatility in value is principally due to the significant income component in total returns. This is driven by the contractual lease structure and the tenant's obligation to pay rent. This income component varies from 70-90%, depending on the market. Furthermore, while real estate demand is closely linked to economic performance, the length and structure of leases can, if properly managed, provide some insulation against both economic downturn and inflation. The combination of these features ensures a relatively low correlation with other asset classes and therefore core real estate can act a ballast to a multi-asset portfolio, as well as a higher-yielding alternative to government bonds. In an era of increasing volatility and uncertainty, this can be a valued reassurance to long-term investors.

2

What about domestic and global real estate investing – how should I view this in my portfolio?

All real estate investors will typically have a home bias to a greater or lesser degree. This is perfectly reasonable, given it is the market which they are most familiar, in which they operate, and likely where they carry a majority of their liabilities. Adding international real estate to a predominantly domestic portfolio can benefit investors in a number of ways.

Firstly, real estate cycles differ across markets, providing diversification benefits and market entry/exit timing opportunities. These can both enhance risk-adjusted performance.

Secondly, expanding into global markets provides access to a much wider real estate universe. This enhances liquidity but also provides investment opportunities by sector, market maturity, or risk profile that might not be available in an investor's home market.

Finally, it is worth noting that many investors first assume they need an additional return to compensate for going abroad, necessitating a move up the risk curve. While this might be appropriate for certain portfolios, it is also reasonable to assume that investors should take additional risk in the market they know best, at home, and at least initially expand into best quality, core global real estate. Ultimately, it depends on an investor's own objectives, but core global real estate can certainly provide an expanded, diversified, risk-adjusted return enhancing addition to any domestic real estate portfolio.

"...core global real estate can certainly provide an expanded, diversified, risk-adjusted return enhancing addition to any domestic real estate portfolio."

3

What are the options for accessing global real estate?

The evident starting point for global real estate is the straightforward acquisition of direct properties. However, in addition to the scale and cost needed to implement such a strategy, is the staggering complexity of undertaking due diligence in multiple jurisdictions with differing practices, tax, and currencies. In contrast, gaining exposure via listed securities can be a low cost alternative to acquire diversified exposure and access expert management without the enormous funds needed for a direct portfolio. Investors also benefit from higher levels of liquidity. The downside is that, in the near-term, these shares are as volatile as the wider stock market. In between direct investment and the public markets lie the unlisted funds, which may be closed-ended or open-ended. They offer a balance between volatility and liquidity, though not all investors may be eligible to invest in them or find them tax efficient, especially cross-border.

Alternatively, other groups could pool resources with like-minded investors and mandate a fund-of-fund manager or multi-manager platform with the operation of their real estate exposure. Here, rather than investing directly or indirectly through a single unlisted fund, a portfolio of unlisted funds is selected by a manager and actively positioned. This removes the concentration risk of being exposed to a single fund (or manager) but adds a layer of fees in recognition of the manager's ability and expertise (and direct time costs) to select and carry out due diligence on funds which are assessed to offer good risk-adjusted returns for a particular strategy. In addition the multi-manager can via its scale and pooling get better investment terms such as lower fees that help off-set some or all of the double fee layer.

4

What have been the impacts of COVID-19 on global real estate?

The COVID-19 pandemic has had a significant impact on the real estate market, turbo-charging trends we were already seeing. In particular, it has fostered a large and general shift of activities online which is affecting most parts of the real estate market. In retail there has been a large rise in online shopping which has boosted demand for the logistics facilities and warehouses used to fulfil these orders. On the other hand traditional bricks and mortar retailers, who were already struggling before the pandemic, have had to contend with the double-whammy of lockdowns forcing shoppers to stay away and the boost given to online sales. For offices there has been a shift to mass homeworking, that has proved largely successful. Other sectors, such as student accommodation and senior living, have also seen their operations impacted.

The investment side of the market has held up remarkably well given the size of the economic shock. This is because central banks and governments learned from previous episodes and delivered a big and fast policy responses. This shored up asset markets across the board, including real estate. Moreover, this crisis originated outside of the economy, whereas the Global Financial Crisis (GFC) stemmed from within it and imbalances that had built up.

We have seen some declines in real estate values though, focused on retail properties, with smaller declines for offices and residential. Industrial property values, on the other hand, have been pretty flat and in some cases seeing increases in value. There has also been uncertainty over pricing, as is usual in times of crisis, and we have seen a sharp drop in transaction activity. The fall in investment volumes has also been brought on by the lockdowns and travel restrictions, which have impinged on the due diligence part of the real estate transaction process. However, we have seen innovative solutions to overcome these challenges, such as virtual tours of buildings.

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What is to become of the retail and office markets in the future?

The crisis is having a significant impact on occupier demand for both retail and office space. In the medium-term demand for both offices and retail will be different from what it has been in the past. The total quantum of retail space needed will be lower. The emphasis will likely be on destination retail which combines shops, leisure, entertainment and dining. There will continue to be demand for local convenience retail and grocery retail. However, large chunks of the retail market will become obsolete, including parts of the high street and lower grade, smaller shopping malls. In reality the disused retail premises will need to be repurposed, or pared back and combined with other uses, such as residential and leisure.

What the office market will look like in the future is also open to debate. The days of employees working in offices 9-5 for 5 days per week are gone. The move to mass home working has proved that it can work from both a productivity perspective and a technological perspective. In the future offices will be used more for collaboration, team interaction and meeting clients. Staff will be given some flexibility over how much time they spend in the office. This has the benefits of both allowing employees to work in ways that better suit their individual lifestyles – also good for attracting and retaining talent for employers – and giving firms the opportunity to reduce their office footprints and reap some cost savings as lease events occur. Many questions remain over how the new set-up will work in practice though. For example, how many and on what days will employees go to the office? However, we think that innovation and learning from experience will hone the new arrangements.

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Is now a good time to invest in real estate and if so, where?

Once the initial uncertainty due to COVID-19 has passed, and economic recovery and virus containment remains on track, we think that the first half of 2021 looks like a potentially attractive entry point into the real estate market for investors. We cite a number of factors which support this. First, with central bank interest rates around or below zero in most countries, and bond yields not much higher, spreads between real estate yields and bonds are attractive, particularly for investors seeking an income. In the US, recent changes to the Federal Reserve's policy framework imply a slightly faster rate of inflation in the medium-term to compensate for low inflation over the past decade, and real estate can help provide protection against this. Moreover, moving into 2021 we think that investors can benefit from the slight pull-back in property values we are seeing this year before they start rising again.

For real estate, the crisis has been much more about sectors than geographies. The convergence of central bank policy rates has leveled the world in terms of hedging costs, whereas before the crisis investments into the US suffered from a sizeable hedging drag. From a risk management perspective, we recommend broad diversification across regions and countries. However, by contrast we think it is sensible to take tactical positions on sector weights, with an overweight to industrial, underweight to retail and around neutral weight to offices as we monitor prospects for this sector. We also think that some of the more specialist and emerging property types, such as labs for life sciences and medical housing, property supporting tech such as data centers and properties with ESG credentials such as affordable housing and environmental living and workspaces provide attractive investment opportunities.

7

How do you incorporate ESG into your investment process and how do you measure success?

As part of our standardized investment process, various ESG investigation and analysis is undertaken on all prospective investments globally. This will include information on target funds' ESG policies, how it incorporates these policies into the property and fund strategy, and how it reports its ESG results to its investors, what relevant ESG laws and regulations impact the fund and any sustainability initiatives the fund is already participating in. There are also social elements to take into account such as the affordable housing sector.

At a property level this means looking at environmental data management systems monitoring consumption of energy and water, greenhouse gas emissions and waste management and setting targets to reduce these. Looking at design and construct efficiency measures e.g. solar panels, thermal energy heating, rainwater harvesting. Also identifying bespoke health & wellbeing measures e.g. cycle facilities, light and air sensors and community engagement programs on the use of communal space.

To measure the ESG results we use the Global Real Estate Sustainability Benchmark (GRESB) which is recognized as the leading global sustainability benchmark for real assets with significant investor and consultant support covering around USD 5.3 trillion of AuM³. This measures the performance of the unlisted property funds against a multitude of ESG metrics and provides a score. Success is measured by having a portfolio of investments that exceed the GRESB benchmark which I'm pleased to say is the case for our products. Where investments fall below the benchmark, they are challenged to improve their scores or risk being sold.

Having an ESG focus on all our investments just makes good business sense. The benefits of these include: limiting the risk of ESG regulatory non-compliance, maintaining properties' competitive position in the market, increasing the appeal of a property to tenants and purchasers, and in many cases, reducing expenses and improving returns for our clients.

" Given the scale of our fund investing and real estate relationships we are able to get access to a wide range of high-quality co-investments that we can offer to our clients. "

8

Investors are looking to do more in co-investments, what is the MMRE business doing here?

Given the scale of our fund investing and real estate relationships we are able to get access to a wide range of high-quality co-investments that we can offer to our clients. A co-investment is typically a large single or portfolio transaction that is too big for a real estate fund to absorb. The General Partner of the fund will offer part of the investment to existing investors of the fund to invest alongside the fund therefore getting concentrated exposure to this asset or portfolio. This is also attractive to investors as the fees are typically discounted, and the assets given their size, are hard to access. For our mandates and increasingly in our fund products we have been active in co-investments over the last few years. This is an area we are looking to expand in and believe it to be an attractive way for larger investors to access real estate in a targeted way.

9

Value-add investing has proved popular with investors as a way of complimenting their core real estate holdings. What are your views on this and your approach?

The investor intention surveys have consistently showed a shift to higher returning value creation strategies over the years. Typically, investors will first build up a diversified core real estate portfolio and then look to compliment that with a smaller but higher returning strategy.

The way value is being created within existing properties is evolving. Historically it meant targeting a property that is "unloved", needs some renovation, but is fundamentally a good asset in a good location. So, some or all of the existing tenants leave and investors are willing to invest some capital expenditure into the building to improve or reposition it. This is with the goal to get new tenants in who are willing to pay higher rents and improve the value of the property.

While this traditional repositioning approach to value creation is still valid, given the current economic and COVID-19 situation we will increasingly focus on thematic strategies in sectors that display potential for strong structural growth. Such allocations will include sectors driven by structural economic paradigm shifts driven by technological change, demographics and aging, changes in consumer preferences and environmental, social and governance trends. These would include life science lab space, last mile logistics, data centers, affordable housing and environmental living and workspaces as examples.

In addition, the economic situation is creating market recovery investments with pricing dislocation, therefore acquiring assets at a discount to replacement cost resulting from market inefficiencies. Through our long and deep market relationships we are able to access a diversified landscape of mispriced opportunities on an attractive entry basis. These opportunities are arising via multiple sources such as corporates selling real estate which is not a core part of their business, banks pulling back on lending as credit markets tighten, recapitalization of property portfolios and real estate funds coming to the end of their life and having to sell assets. We have invested in value creation strategies over the last 10 years and realized double digit returns for our clients⁴. We are especially well positioned to continue to do this now given the current market disruption.

10

What role can real estate debt play in an investor's portfolio?

A real estate debt fund is a private pool of capital that lends to prospective or current owners of real estate. Due to the lower levels of bank financing since the GFC this part of the debt market has grown. The lenders can invest across the capital stack, but typically provide senior or mezzanine debt that is secured against the real estate asset. Lenders use a variety of restrictions, or covenants on their borrowers to protect their capital. This includes loan-to-value covenants where a borrower must ensure the loan does not exceed certain value and/or interest-coverage-ratios where the interest payments must be covered by a certain ratio of income from the property. If they are breached, they have certain recourse such as taking ownership of the underlying asset.

Investing in real estate debt can complement both a multi-asset portfolio as well as a real estate portfolio. It allows for stable income returns in this low interest rate environment and given the reduction in bank financing provides a good yield which makes them preferable to other income instruments, most notably government bonds. Holding both commercial real estate debt and equity in a portfolio can further help diversify and potentially reduce overall portfolio risk as commercial mortgages for example have historically a low correlation to core real estate equity. In addition, floating rate debt can further hedge against inflation and against rising interest rates. Finally, real estate debt investments are low volatility investments relative to returns, adding to the diversification benefits within a portfolio.

We have been investing in real estate debt funds for a number of years now for our clients and see this expanding as investors hunt for stable income returns.

" We have invested in value creation strategies over the last 10 years and realized double digit returns for our clients⁴. "

Notes: **1** All data as at 30 September 2020, unless otherwise stated. **2** Equity includes both invested and committed assets. **3** Data based on 2020 GRESB Benchmark Reports. **4 Past performance in not indicative of future results.**

For more information, please contact:

UBS Asset Management

Real Estate & Private Markets (REPM)

5 Broadgate

London

EC2M 2QS

United Kingdom

+44-207-567 8000



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