Real estate

More markets are thriving, but it's critical to understand regional nuances

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Key takeaways

- More real estate markets are now doing well, notably several in Continental Europe.
- Pricing remains competitive, however.
- Perhaps the most important secular trend is new technology.

An increasingly synchronized economic upswing, the first since the global financial crisis, continues to support real estate market fundamentals around the world. More markets are now doing well, notably several in Continental Europe. This is a great positive and is creating opportunities for real estate investors.

Pricing remains competitive, however. The weight of capital chasing income-producing assets has driven yields/cap rates to historic lows in many locations. There is concern in some places, particularly in the US, that we may be getting a little late in the cycle. This has focused our attention on the importance of two global execution themes:

- A focus on bottom-up, asset-level drivers of real estate returns
- Investing with tailwinds from secular trends

Asset-level drivers

For the next few years, we believe that a hands-on, active management approach in real estate is likely to influence performance more than simple market and sector selection. This insight encourages us to look for very specific, very granular investment opportunities that are appropriately priced. This applies worldwide, but there are nuances in each region. For example:

- **Asia Pacific.** We have identified cities where we believe the historic volatility of rent cycles may be moderating, and within them specific submarkets where we believe rent growth potential remains strong this cycle. An example is office buildings in Tokyo, outside the central three wards, in places like Shinjuku or Shinagawa. We look for buildings that rent for an average of JPY25,000 per tsubo or less, with pockets of strong tenant demand.
- **Europe.** We are focusing on sustainable locations around transportation hubs, flexible assets that can adapt to rapid technological change, and mixed-use opportunities that tap into the "live-work-play" drivers of growth. Examples include Amsterdam, Munich or Berlin. We believe value-add, build- or manage-to-core strategies may offer better risk-adjusted returns than fully-let, completed buildings.
- **United States.** We favor submarket locations with low levels of new supply; this applies particularly to the apartment sector, which now has more tepid fundamentals. Locations driven by growing activity in value-creation industries or by new infrastructure development are also of interest. In competitive job markets, where tenants need to offer compelling workplaces to attract employees, we believe locations that offer a differentiated product are likely to outperform bland, commodity buildings and locations. Given all this, we believe that the differences in real estate performance between US cities are likely to be less than the differences between assets and submarkets within those cities.

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Positive secular trends

Late in the cycle, a potential way for real estate investors to mitigate cyclical risks is to invest where there are tailwinds from secular trends in demography, infrastructure and new technology.

Perhaps the most important trend is new technology and its implications for real estate. Five aspects are beginning to have a significant effect on real estate:

- **E-commerce/sharing economy.** This is creating leasing demand for logistics and data center properties but is having a more differentiated impact on office space and a largely negative impact on the retail sector.
- **Job automation and artificial intelligence.** These technologies are having a net positive effect on demand in tech-centric office locations, but a net negative impact on back office demand; experiential retail could become more virtual and change storefront demand.
- **Autonomous vehicles.** Autonomous trucks may help to reconfigure supply chains given the potential to create longer delivery routes. Longer term, the need for parking and road space could be reduced, offering the potential to transform urban areas
- **Drones.** Efficient delivery systems could reduce the need for last-mile logistics facilities, but they may also necessitate a redesign of some buildings to accommodate drone deliveries, which could provide a new source of building revenue.
- **Robots.** These could transform manufacturing and distribution processes and change today's standards for building services. For example, buildings that house robotic processes could require less light or less heat/cooling, but more secure power sources and internet connectivity.

We do not pretend to have all the answers at this stage – there will likely be winners and losers, but we believe that multi-family housing, logistics, certain types of retail assets and some specialty sectors may be the beneficiaries of trends in new technology.

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Regional investment themes

As ever, there are important local and regional nuances within our global themes, which provide opportunities for active management within each region:

- **Asia Pacific.** Over the last year, returns have been strongest in Asia Pacific. Overall, we have upgraded our rent growth forecasts. There is a wide variety of city-level outlooks, and we are mindful of the emerging opportunity to invest with the cycle in places like Singapore and Brisbane. We favor asset enhancement strategies through lease-up opportunities or physical upgrades in places as diverse as Melbourne/Sydney and first-tier cities in China.
- **Europe.** Real estate market fundamentals are now strengthening in much of the eurozone, and there remains strong international and domestic investor demand. While we believe net operating income growth is the key to outperformance, we also believe that the creation of new and refurbished space seems to be a particular opportunity. The changing logistics sector is of particular interest. So too are the multi-family and hotel sectors.
- **United States.** The US is probably further along in its real estate cycle than other regions. Strong embedded net operating income growth is expected to drive returns despite moderating rent growth in some cities and sectors. We are focusing on asset-level drivers, considering specialty sectors that appropriately expand the universe of core real estate, and considering debt strategies that appear to offer attractive risk-adjusted returns.

Global Strategies

The outlook for real estate returns is positive and broadly similar in each region, in our view. It is important to note that there remains considerable geopolitical, political and economic policy uncertainty around the world. Given this, largely for risk reasons not return reasons, in our unlisted global core portfolios we continue to adopt a neutral weight to each region. At present there is not a sufficiently clear pattern of durable outperformance to take regional tactical positions in a relatively illiquid asset class.

Conclusion

The generally stable income return from listed and unlisted real estate continues to attract investors to the asset class. A synchronized global economic upswing is helping drive differentiated growth at an asset and submarket level, which provides fertile conditions for active real estate investment management strategies.

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