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Europe Roundtable 2023

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Sailing in a different ocean

After enjoying more than a decade of cheap money, the new cost of finance and growing risk of obsolescence have pushed European real estate into entirely different waters, writes Mark Cooper

European real estate markets turned in 2022. Interest rates, having been so low for so long, were dramatically and repeatedly hiked to stave off inflation caused by the war in Ukraine and years of loose monetary policy. Real estate, for so long a beneficiary of that monetary policy, was rocked as yields rose and transaction volumes fell.

Meeting in mid-January, *PERE*'s 2023 Europe roundtable reflects on a year of upheaval, and expects more to come as real estate values adjust to the new market situation.

This year, the pace of that value adjustment and the pressures caused by refinancing at a much higher cost will drive decisions. At the same time, the industry must battle with structural changes in working habits and the pressure to decarbonize, which will affect every facet of real estate investment.

With Europe's import-reliant energy supply exacerbated by the war in Ukraine, inflation rose to double digits in 2022. In response, the European Central Bank raised interest rates from 0 to 2 percent in the space of a few months, while the Bank of England hiked rates to 3.5 percent by the end of the year. Both banks have since made further rises: in early February, the ECB set the rate at 3 percent, and the Bank of England at 4 percent.

Real estate transactions fell dramatically during the year, with MSCI Real Assets data recording a 66 percent year-on-year drop in volumes in the final quarter.

Meanwhile, the MSCI Europe Quarterly Property Index fell 9 percent in the third quarter of 2022, the latest data point available, and the index was down 11.9 percent for the six months to end-September 2022.

Yield movements are largely responsible for dealflow drying up. The JLL European Weighted Office Yield, for example, moved out 62 basis points to 3.67 percent over the course of the year.

Although the real estate industry globally has been rocked by a general tightening in monetary conditions, European investors appear the least optimistic for the year ahead.

The *2023 Investment Intentions Survey* conducted jointly by industry organizations ANREV, INREV and PREA showed Europe as the only investor domicile with a net negative near-term allocation position: the average current allocation is 10.8 percent, above an average target of 10.5 percent. Over the 2023-24 period, 37 percent of Europe-based respondents to the study plan to decrease allocations globally, versus 16 percent that expect to increase them.

Since most European investors have the bulk of their holdings in their home region, this planned disinvestment will hit Europe the hardest.

The rapid shift of the economic

PHOTOGRAPHY: **WILLIAM COOPER**

Marc Fuhrmann

Principal and head of real estate, Arrow Global Group

Fuhrmann joined Arrow Global in 2021. Arrow is a vertically integrated European fund manager operating in European credit and real estate. Arrow manages €70 billion of assets for third-party clients including €10 billion of real estate AUM. Previously he spent nearly 14 years at Fortress Investment Group.

Sophie van Oosterom

Global head of real estate, Schroders

Van Oosterom joined UK investment manager Schroders in 2021, after spending more than seven years at CBRE Global Investors, where she was CIO and CEO for EMEA. Before that she was European head of asset management at Silverpeak Real Estate Partners, previously known as Lehman Brothers Real Estate Partners.

Stéphane Theuriau

Partner and head of BC Partners Real Estate

Theuriau joined UK private equity manager BC Partners in 2018 to launch its real estate business and closed a €900 million European debut fund in 2022. He joined from French listed real estate company Altarea Cogedim, where he was group chief executive. Previously, he led Morgan Stanley's European real estate investing business.

Adrian Benedict

Head of real estate solutions, Fidelity International

Benedict joined London-headquartered Fidelity International in 2008 and subsequently built a European real estate business which has approximately €3 billion of assets under management. He is also chair of The Association of Real Estate Funds, a UK body. He previously worked for Invista Real Estate and UBS.

environment in Europe may well be to the region's advantage, however, as prices will adjust to a new floor more quickly than elsewhere.

Sophie van Oosterom, global head of real estate at Schroders, says: "Europe faces different and, to some extent, bigger challenges than the other continents, but as pricing adjusted quickly, it is probably seen as the area of the greatest opportunity too. Specifically, in the UK, pricing adjusted quicker based on a more 'willing' seller community, caused by a search for liquidity to deal with margin calls by parties caught out by the bond yield spike, which resulted from the 'mini budget' announcement in September.

"I've recently been in the US and Asia; investors from both regions have their eyes on Europe. The US, which is normally earlier to reprice, is still assessing a recession scenario and revaluations are only just beginning to happen there, while Asia has had a longer tail of covid-related issues."

Adrian Benedict, head of real estate solutions at Fidelity International, agrees: "What surprised me here in Europe is the pace of that downward correction, which is encouraging to see. Our industry is so sentiment driven; if we see aggressive valuation markdowns in Q1, then you will see investors returning more quickly. We know the opportunistic funds will be there anyway, but the question is when will the core and core-plus investors start to step in?"

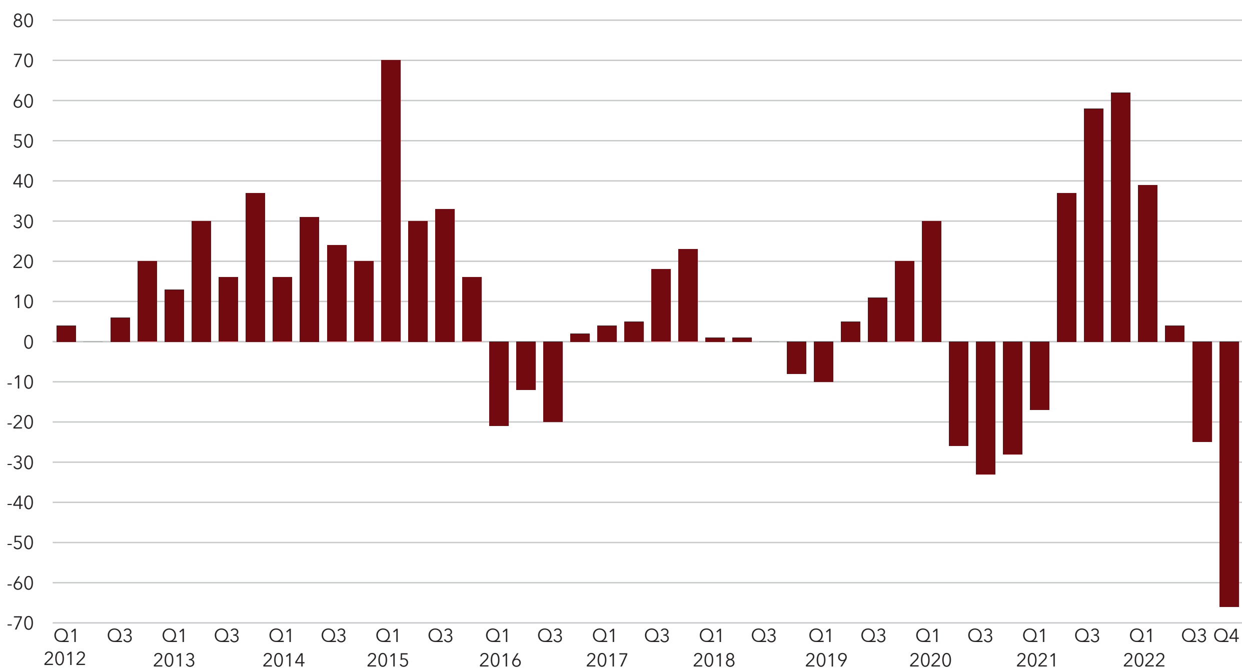
There is also an argument that Europe has more to deal with than other regions, however. Inflation is higher and more stubborn than in the US and Asia-Pacific, especially in the UK, where it was still in double-digit territory at 10.5 percent in December 2022, while eurozone inflation stood at 9.2 percent. In comparison, US inflation was only 6.5 percent. European economies have yet to digest this pressure.

Marc Fuhrmann, principal and head of real estate at Arrow Global Group, says: "There is repricing, but I think there's also reason to be cautious, because we have yet to see the effect of higher energy costs and higher interest rates flowing through the economy. We are only just seeing the changes in consumer behavior and corporate layoffs you see in a in a down cycle. There is potentially a 12-24 month lag between a big macro event and it really flowing through to occupiers and ultimately the investment market. I think we'll be dealing with the consequences in some sectors for the next 18-24 months."

European real estate also faces a wave of recapitalizations as funds refinance in a very different lending environment. Stéphane Theuriau, partner and head of BC Partners Real Estate, says: "There are many assets financed in 2018, with a 1.5 percent cost of debt, which will be up for refinancing soon, where the cost of debt is going to become 5-5.5 percent. And you may not even have the same quantum of debt. So, we are going to see some fairly quick repricing."

Furhmann adds that there were €500 billion of private equity real estate acquisitions in Europe between 2015 and 2019, by funds that are coming to

European real estate transaction volumes fell sharply in 2022 (year-over-year change, %)



Source: MSCI Real Assets

> *"Whenever we see the right repricing for the right location, we are open for business"*
>
> **STÉPHANE THEURIAU**
> **BC Partners Real Estate**

the end of their life and which may be highly leveraged.

In such an environment, what have real estate investment managers been doing? The simple answer is, not so much. Benedict says: "We ask how long the rate-rising environment will last, are we close to the top and what will our exit yield be in three, five, seven years' time? In the absence of really having a view on that, quite frankly, we've not been comfortable to deploy much, if any, capital in 2022. The capital we have been deploying has largely been going into the life sciences and a little bit in logistics. In logistics we have seen some signs of more realistic pricing, but sellers haven't moved enough yet. And if you want logistics, then SEGRO bonds are priced at 6 percent."

Meanwhile Theuriau, who closed BC Partners' debut real estate fund at the beginning of 2022, says: "We have done on average smaller tickets in this environment because smaller assets offer more liquidity. A lot of our exits are predicated upon selling to family offices and high-net-worth individuals, people who will always want to park money in real estate.

"Whenever we see the right repricing for the right location, we are open for business, but we don't see a huge opportunity to buy cheap now in the expectation the market will go back where it was with zero interest rates."

Arrow Global is similarly looking for discounts, "and also to make sure that we are doing something smart, say, that one of our platforms can operate the asset better," says Furhmann, while Schroders has been concentrating on

Hard to spot a key deal

The panel finds little to shout about from a tough 2022

At *PERE* roundtables, participants are often asked to choose a landmark deal from the previous 12 months that they consider impressive, novel or indicative of market trends.

That exercise proved rather challenging this time. Panelists were scratching their heads to think of any deals worthy of note in Europe, with several instead citing the University of California's $4 billion investment in Blackstone Real Estate Income Trust, a $69 billion non-listed REIT that was forced to limit redemptions in November 2022. Panelists felt the transaction was both innovative and reflective of the state of today's real estate market. However, Marc Fuhrmann of Arrow Global was able to name a noteworthy European transaction. He cited the Project Crow deal in Portugal, which closed at the end of last year, 12 months after an initial offer was accepted. The €850 million deal saw New York-based alternative investment management firm Davidson Kempner Capital Management acquire a portfolio of Portuguese hospitality assets from several banks.

"It was an incredibly complex deal to hold together, involving negotiation with multiple bad banks," says Fuhrmann.

A new pool to fish from?

Sector recapitalization could bring new investors to real estate

European real estate needs recapitalization as asset owners refinance in a higher interest rate environment, and as institutions contend with the denominator effect, where real estate holdings exceed allocation due to falling values in other asset classes.

This could incept a shift in the type of investor active in the asset class. Schroders' Sophie van Oosterom says: "A number of institutions are temporarily locked out of the market for new real estate acquisitions by the denominator effect, so the opportunity will arise for other investors such as family offices and private wealth funds, as well as sovereign wealth funds without allocation boundaries, to step in and take some of the opportunities arising from the need for recapitalization."

That said, there are concerns about the appetite for real estate in a higher interest rate environment. Stéphane Theuriau of BC Partners Real Estate says: "The big question is how much money will there be for real estate going forward now that you can buy government bonds in, say, France at 3 percent today?"

Fidelity International's Adrian Benedict says: "I think the biggest challenge that we have as an industry is that there's so much more competition for capital than ever before.

"The challenge isn't so much the traditional asset classes, it's actually in the other areas of the private space, such as private credit."

He suggests real estate's drive toward net zero could be an avenue to attracting a new generation of real estate investor.

"The key issue for 2023 is the recapitalization of the whole sector. For me that recapitalization means bringing in non-institutional capital. Real estate is built on institutional capital and we have been talking about how to convince that capital to make the ESG investments necessary to drive decarbonization.

"However, if I'm trying to convince my children's generation, it's going to be a lot more straightforward, because they target a broader set of outcomes than purely financial ones."

improving its book rather than adding to it.

Van Oosterom says: "In recent years we didn't count on any further cap rate compression so focused our acquisitions on assets where we thought our platform could truly add value though asset management.

"During covid lockdowns, our hotels set an example by improving operational efficiency, moving fixed costs to variable costs and reducing waste of scarce resources in operations, as well as transitioning for new tenant demand. When business opened up, increased revenues went straight to the bottom line. We've applied that same 'operational excellence' approach to every asset class. We want to manage every building as if it's a business by itself."

Offices under pressure

The office sector, still the biggest investable commercial real estate sector, presents the panel with the greatest

The MSCI Europe Quarterly Property Index dropped in the third quarter of 2022

Source: MSCI

cause for concern – it is under pressure from all sides. Secular trends in the workplace and regulatory pressure around environmental, social and governance issues are laid on top of pricing pressure from rising interest rates and the uncertainty surrounding the tenant market in a downcycle. Nonetheless, this complex mix is expected to throw off opportunities.

Theuriau says: "In the US and Canada office towers have been closed because people no longer want to work there. This is not about cap rates anymore. It is about: is there a tenant? How much will they pay? How can we transform these assets?"

The office sector can be divided into two distinct markets, van Oosterom says. "Those assets with sustainable credentials and operations, which are well located, have good tenant facilities and a layout to cater to new office demands – such as interactive meeting rooms or Zoom breakout spaces – will do well. Those which do not meet this standard will struggle and the capex to be invested to transition to operational net zero will be priced in, which means values are likely to fall off a cliff quite quickly. The opportunity lies in the fact that there is not enough space in the first category to service demand."

She adds that the picture varies from market to market. "We have heard opportunistic funds in the US saying offices are uninvestable, and there is a clear case if you look at the return-to-work trends in New York and available stock. However, these same funds are the highest bidders for some of the offices on sale here in London, albeit at an already adjusted price point and benefiting from a stronger dollar, but also given a different market dynamic."

Creating sustainable offices which support new flexible working practices was agreed to be a sound strategy going forward, not least because of the shortage of such assets across Europe. Fuhrmann says: "The scarcity of sustainable offices cannot be overstated. A Dutch bank commissioned a study into bringing all of its European branch offices to net zero by 2030, but was told it was simply impossible. So, if you have sustainable assets with amenities, in a multifunctional location with good connectivity, you will achieve higher rents."

"The scarcity of sustainable offices cannot be overstated"

MARC FUHRMANN
Arrow Global

However, the panel worries that many assets across the region are redundant, but their owners do not realize. If a tenant is in place, the book valuation of an older office building is supported, but should a tenant vacate, the building's shortcomings mean it will not re-lease and so it only has value as a redevelopment opportunity. "In a lot of major markets, you have office buildings that were designed 10 years ago which are already obsolete," says Theuriau.

Van Oosterom agrees: "Given how strict both tenants and regulations are becoming over CO2 emissions and broader sustainability credentials, there is a big risk of stranded assets."

ESG issues, primarily the pressure for the industry to decarbonize, are front and center for European real estate. The *2023 Investment Intentions Survey* found European investors are firmly in the lead in this regard, with three-quarters already incorporating

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> **ADRIAN BENEDICT**
> **Fidelity International**

climate change into their real estate investment decisions. Equally, more than 90 percent consider funds' net-zero carbon commitments before investing.

Fuhrmann says: "There was a worry a couple of years ago that covid was actually displacing sustainability from the agenda. I'd say that, if anything, the current dislocation has had the opposite effect. If energy is more expensive, you're more incentivized to worry about saving.

"Also, in an environment with a lot of uncertainty about interest rates and economic growth, people tend to focus on the things they can count on. So, 2030 is now two years closer, these regulations are coming, and they're going to drive tenant behavior and investor behavior."

Environmental regulation requires a change of approach in many cases. For example, embodied carbon – the emissions resulting from the construction of a building – is now being factored into calculations for new developments. Some planning authorities, including the City of London, have blocked development plans due to their overall carbon impact.

"Increasingly in real estate, the whole supply chain is taken into account when assessing total CO2 emissions," says van Oosterom. "If you want to create a new building, then the embedded carbon for your new build and the supply chain, as well as what you are demolishing, will get counted. However, this current repricing of carbon also provides an opportunity to have a positive impact on returns and the environment."

Meanwhile, more and more real estate managers are investigating onsite power generation, which is becoming more viable as energy costs rise and the cost of solar PV, the most popular option for onsite power generation, falls. "We are going to see some level of convergence between renewable energy and real estate," Theuriau predicts.

However, there is concern that real estate managers are not reaping the rewards of making their buildings more sustainable. MSCI research into the London office market suggests a 20 percent sales premium for the most sustainable assets, but this 'green premium' varies across sectors

The listed opportunity

Discounts could open the door to more take-private deals in Europe

European-listed real estate offers opportunities to acquire assets or to take public companies private. As MSCI data shows, listed real estate companies have underperformed the wider stock market in recent years and many are trading at below net asset value.

Stéphane Theuriau of BC Partners Real Estate says: "I think you are going to see some private equity or activist investor action around the public real estate sector. I'm baffled we don't have more activist investors in listed real estate, as I think a lot of management teams find themselves in a strategic deadlock with share prices trading at huge NAV discounts.

"I think there'll be some take-privates and/or activist action, which will try to close the gap between asset values and share prices."

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>
> **SOPHIE VAN OOSTEROM**
> **Schroders**

and markets. Theuriau insists: "CO2 compliance only makes your assets liquid from a rental standpoint, but in my view, we haven't seen the return on that investment yet."

End-investors, especially European pension and insurance funds, have been driving the real estate industry to be greener. However, there is concern that investor return expectations do not match with the risk/return profile of more sustainable assets and their additional costs.

Benedict says: "The question is whether our investor base is prepared to accept the modified return profile for more sustainable assets. We know what needs to get done in order to deliver a longer-term sustainable return profile, but are our clients actually willing to accept a slightly lower return for the risk they're taking on?"

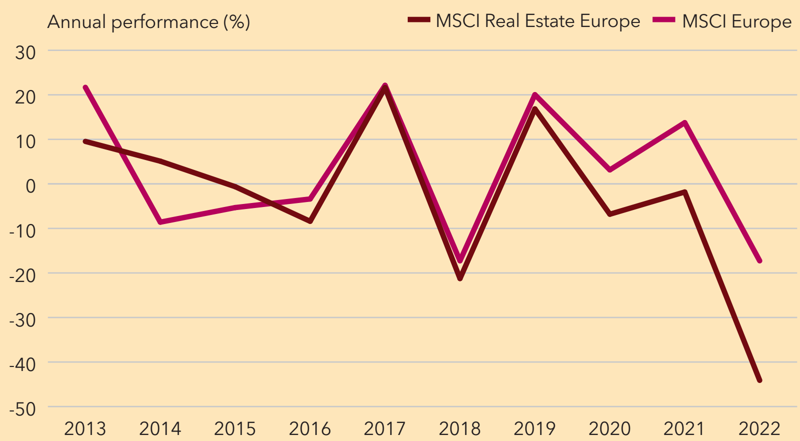
As the European real estate market digests higher financing costs, funds coming to the end of their life and the need to deal with potentially redundant assets, there is a lot to contend with, but the panel clearly sees opportunities emerging. One factor expected to be key to success is the ability to get hands on with properties to add value.

"In this environment you need good asset management," says Theuriau. "We're at the beginning of a huge capex cycle, in my view, driven essentially by obsolete office space, which is going to create a lot of opportunities. One of the ways to play this is to selectively buy development companies – they're cheaply valued. So, you're buying companies which are in the business of producing real estate, at the beginning of a new capex cycle."

Van Oosterom adds: "Opportunities are already arising where investors are facing issues on the financing or refinancing costs of existing assets, or when investors have no direct management teams on the ground and need to take action because the building is facing tenancy issues or has become empty."

Benedict sounds a note of caution, however. "I think that 2023 is going to be one of those years where there's going to be a lot more clarity. But we might be just a bit surprised about how much capital will still remain on the sidelines." ■

European-listed real estate has underperformed the wider market in the past decade



Source: MSCI