CAVENDISH
FAMILY OFFICE

Thought Leadership

Hot (& cold!) property

12th April 2023

What are the most exciting trends in real estate in 2023, and where do investment opportunities lie? We get to the bottom of both in an in-depth conversation with Philippe Peirs, Managing Director, and Head of Real Estate, at Nevastar Finance - an independent international financial investment firm founded in 2003 that acts as investment manager of professional clients. Discover why logistics and light industry is 'hot property' and how you can take advantage of the current market conditions.

How have rising interest rates and COVID affected the global RE market?

The COVID-19 pandemic had a sudden and profound impact on global real estate. Entire office blocks lay empty, new constructions halted, and global supply chains stuttered. As restrictions were lifted, we saw some interesting new trends emerge.

The shift from a 'just-in-time' to a 'just-in-case' supply model and surging online sales drove record rental growth and low vacancy rates in the Logistics/Industrial sector as firms grappled to build more resilient supply chains. In Offices, as firms have struggled to encourage staff back to their desks, we have witnessed a 'flight to quality' with tenants looking for the highest quality spaces in terms of location, fit out, and amenities.

In 2022 Central Banks felt the need to act as they raised interest rates to curb double-digit inflation largely driven by post-COVID supply chain disruptions combined with geopolitical events in Eastern Europe. Dramatic increases in borrowing costs forced the re-evaluation of real estate deals and what ensued was a fall in transactions as the gap between the expectations of buyers and sellers widened. So far in 2023, we have seen interest rates begin to trend towards the historical norm and valuation expectations reset.

Which sub-sectors within real estate are the winners?

Using a broad brush, the investible property sector is traditionally broken down into four main categories:

1. Offices (the larger in value terms),
2. Retail,

3. Logistics/Industrials and
4. Demographics (i.e., Living, including hospitality).

It is always perilous to make sweeping generalisations but, to give you a general sense of how we perceive things at present, we would advocate as follows: despite all the recent headwinds, Logistics/Industrials and Demographics continue to benefit from robust occupier demand combined with structural under supply, so retain positive outlooks across most geographic areas. 'Beds and Sheds' (hotels, warehouses and so on), which has been growing as an investment theme for several years, continues to lead the pack from a risk/reward standpoint.

Which sub-sectors are the losers?

Conversely, the two most traditional real estate sub-sectors, Offices and Retail (ranging from high street outlets to out-of-town parks, outlet centres and shopping malls), are currently faced with a multitude of challenges, some old, some new, that are unlikely to go away in the foreseeable future. For instance, Retail, which has been under pressure from the continuous rise in e-commerce penetration since the early 2010s, is even more under scrutiny post the COVID pandemic. This means that further restructuring plans, asset repositioning, and re-inventing of operational models are on the cards for the coming years.

Again, it is worth observing that the ancient property adage of "location, location, location" remains alive and kicking. The best spots have by and large retained - and will continue to retain - their scarcity appeal, irrespective of their use.

What more can you tell us about the Office sub-sector as an asset class?

As you are certainly aware, the 'Office' sub-sector is by far the largest property sub-sector worldwide and forms a central part of a large majority of property portfolios, its significance is therefore massive. As is the case for any other real estate asset, office asset valuations are sensitive to interest rate levels. As such, when base rates increase, as we have been experiencing over the last 12 months or so, valuations tend to soften. This is a well-trodden path and investors are fully aware of such 'market cycle' mechanisms.

What makes the situation palpably different this time is that two other drivers are currently at play, which create material additional headwinds:

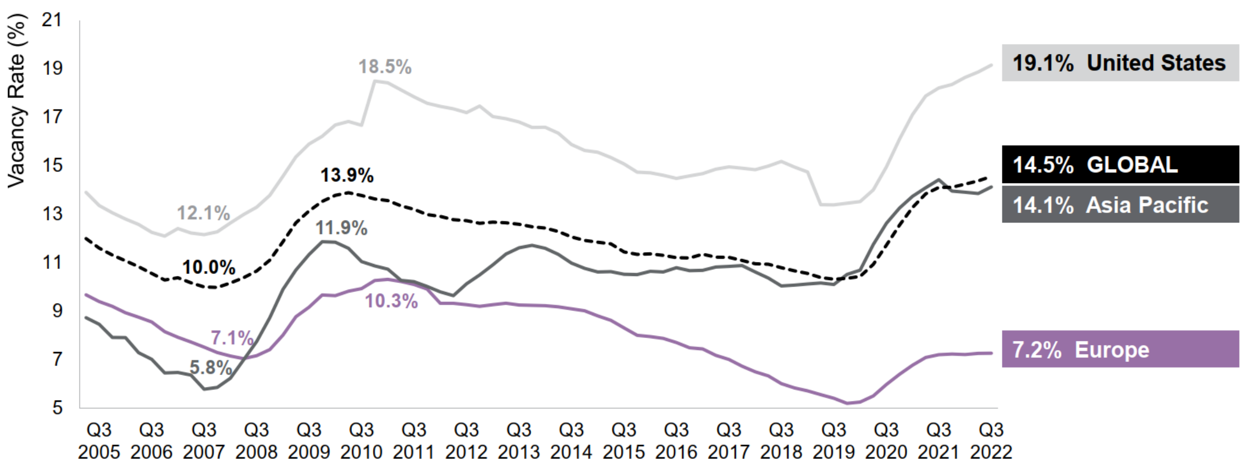
- The pandemic has clearly accelerated the pre-existing macro-trend towards flexible, 'work-from-anywhere' office usage, creating additional uncertainty on occupiers' space and format requirements going forward.

Cavendish Family Office (London) Ltd Registered in England No. 11213617
Registered Office at 1st Floor, 3 Sharrow Lane, Sheffield S11 8AE
VAT Number - 327 7076 88

- Capital expenditure obligations for low emissions and energy efficiency retrofitting purposes are increasing, partly due to a rapidly evolving legal and regulatory environment, as well as more stringent sustainability-related bank covenants on mortgage financing.

The convergence of these various challenging factors is currently taking hold: vacancy rates are on the up in most jurisdictions, rarefied prime-quality assets are outperforming, leading to increasingly bifurcated sub-markets, transaction volumes have decreased and are likely to remain subdued owing to elongated decision-making processes.

Global and regional office vacancy rates, 2005-2022:



57 markets in the U.S., 23 markets in Europe, 25 markets in Asia Pacific. Grade A space vacancy only for Asian markets
Source: JLL, October 2022

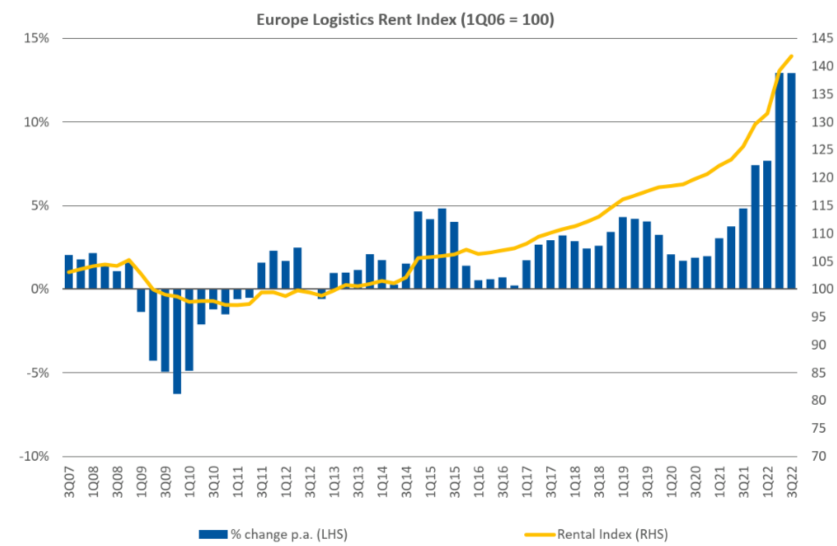
What else can you tell us about the Logistics / Industrials space?

From being seen as the 'poor cousin' of the real estate family up until the global financial crisis of 2008/2010, the Logistics and Light Industrials sub-sector has experienced an extraordinary run over the last decade, effectively becoming the most sought-after property sub-asset class.

The massive expansion of e-commerce has obviously played a key role in this change of fortune and will continue to run its course, particularly in jurisdictions lagging in terms of market penetration. A string of other factors is also contributing to this trend, providing further structural impetus to the asset class.

True, valuations have been hit and transaction volumes have slowed during the second half of 2022 owing to the rising interest rate environment, but fundamentals remain generally very strong. Vacancy rates are stuck at rock bottom levels and rental growth has accelerated. All in all, we are positive on the outlook and continue to find this space decidedly attractive.

European Logistics change in rental rates, 2007-2022:



Source: CBRE, 2022

What are the current trends and opportunities?

We have clearly entered a phase of higher volatility and market adjustments against a backdrop of slowing economic growth, technological disruption and shifting regulatory landscape. Sophisticated property investors will find ways to take advantage of these new circumstances, though the next 12 to 18 months are unlikely to provide plain sailing conditions for most.

In our view, a space that will continue to remain attractive is non-bank real estate lending. With traditional banks increasingly restricting their exposure to the sector, there will be possibilities to generate attractive risk-adjusted returns, whilst securing improved terms and conditions compared to pre-COVID.

Selective investments in defensive demographic-related strategies such as self-storage, healthcare, mainstream residential, or education real estate should also prove well-positioned. Whilst it seems probably a little premature to engage in more aggressive 'recovery plays' targeting challenged assets, this will probably become increasingly relevant as 'distress' situations begin to emerge across sub-sectors and regions. Interesting times ahead, no doubt!

How does Nevastar propose to take advantage of these trends in the marketplace?

Nevastar Finance has a thematic, top-down approach to investing in real estate whereby we identify specific niches across different geographies and sectors that we believe offer attractive characteristics in terms of return profiles, liquidity, decorrelation, and volatility. Given the current macro-economic environment and real estate cycle, our current aim is to source and propose investment opportunities mainly based on 'Alpha generation/portfolio aggregation/value-adding tactics', capable of generating 10% to 15% net IRR, including some running yield, over a 5-year hold period.

We are currently in the process of taking advantage of the defensiveness presented by the UK junior education property sector. This sub-sector sits in our Demographic bucket given the severe shortage of high quality, fit-for-purpose educational facilities across the UK. As a pure real estate landlord (no exposure to the operations), we found this sector to be particularly attractive, as where Offices have struggled to continue securing long leases from commercial tenants, the average new lease being achieved in the education sector is in excess of 20 years, all linked to Consumer Price Index (CPI), offering an attractive yet secure annual income yield for investors.

Another way we have addressed Demographics was in 2018 when we put together an aggregation strategy to acquire income producing residential across Northern Germany. We targeted assets that were already producing income however were underperforming either due to lack of management, capital, or both. Through active asset management initiatives, we were able to significantly reduce vacancy (currently stands at 4%) and bring rents up in line with the market to enhance overall rental income and stimulate capital growth.

Another strategy we are contemplating for 2023 is in relation to addressing the supply shortage observed in the logistics sector through developing grade A logistics warehouses in core Continental Europe. We believe this sector will continue to benefit from the tailwinds described above in terms of e-commerce penetration and shift to the 'just in case' supply model. Also, by facilitating ground up developments you are not only helping to solve the supply issue, but we would also not have to deal with asset obsolescence, a key headwind affecting the office sector at present, for instance.

Conclusion

As can be seen from all of the answers above, real estate is a complex area with potential investment opportunities for the well-initiated, well-informed, or well-advised. If you are considering allocating capital to real estate, please do get in touch, we'd be happy to help.

Cavendish Family Office (London) Ltd Registered in England No. 11213617
Registered Office at 1st Floor, 3 Sharrow Lane, Sheffield S11 8AE
VAT Number - 327 7076 88

Mark Estcourt, CEO
Cavendish Family Office
mark@cavfo.com
www.cavfo.com

Philippe Peirs, Head of Real Estate
Nevastar Finance
philippe.peirs@nevastar.com
www.nevastar.com

Mark Estcourt
CEO at Cavendish Family Office