Why core is back

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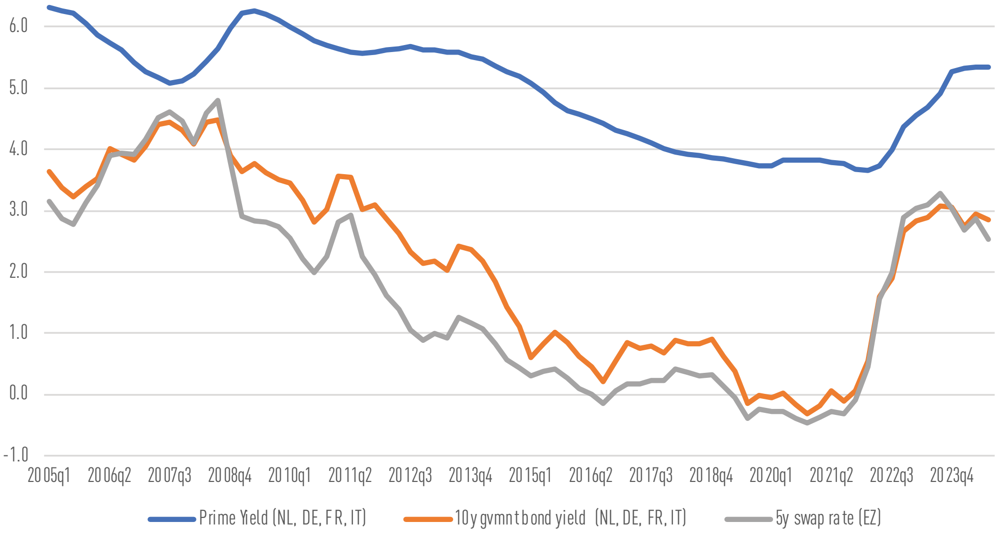
After a period of economic and geopolitical uncertainty, higher debt costs and squeezed returns, we have reached a turning point in the market cycle for core real estate investment.

The interest rate landscape is tilting in a more positive direction; loan margins are diverging with leverage now accretive again for lower risk high quality investments; and pricing has adjusted with limited re-pricing risk looking forward. With further interest rates cuts forecast, the outlook for yields is more stable and material recovery in real estate values is expected.

Despite the market turbulence, rental growth for core assets across most sectors has remained strong. This has been particularly pronounced in core residential, logistics and prime offices. Occupier demand remains and is sustainable, and attractive market fundamentals are supporting positive rental growth outlooks and returns.

These dynamics are creating a tailwind for capital coming back into core real estate, making now a good entry point.

Prime property yields follow interest rates with a minor lag — Normalization returns to property capital markets after yield-to-SWAP spreads contracted through to the end of 2023, with yields showing signs of stabilizing.



Sources: Oxford Economics & CBRE, data as of Q3 2024.

How core has evolved

Core portfolios have evolved materially over the last 15 years. The market has seen a major shift in portfolio weightings towards logistics and away from retail, which has been well-documented and driven by the rise of e-commerce and changing retailer value chains.

In the office sector, there's been a dramatic change in what would have once been considered a 'core investment'. Whilst in years gone by, this would have encompassed both primary- and secondary- located buildings, now it's very rare to consider anything but a central location for core office investments because of the changing occupier demands and use-models post-pandemic. The office as an asset class is not dead, but there remains a lot of uncertainty around the sustainability of occupier demand, due in part to changing attitudes towards home-office and remote working trends. This uncertainty has been a driving force behind the more significant repricing in the office sector. At AEW we believe there will always be a need for offices which provide the best space in the best locations, which is why prime offices is one of our conviction sectors.

Sectors that were once considered niche, are now more mainstream. Occupier fundamentals across the residential sector are enormously favourable. Changing working patterns, living models and household composition, and a population that is generally more mobile, have led to growing and sustainable demand for sub-sectors such as co-living, micro-apartments, senior living and student housing. As operators in these subsectors have matured and consolidated, they have become more appealing to core institutional investors.

What this demonstrates is how quickly the occupiers' operating environment and requirements can change and in turn disrupt the way in which real estate is used. Some investors have suffered in the past from a perception that real estate was a more static investment, but well managed core portfolios look different to what they did 15 years ago and will continue to evolve in years to come. As an investment manager, it is essential to understand what occupiers need from their space, and how they perceive the value they extract from the areas they occupy. Core assets must be fit-for-purpose, reflecting not only the needs of today's occupiers but also those of occupiers in the future.

This underlines the importance of diversification, flexibility and the need to adapt to the future. Core doesn't mean buy and ignore; it requires active portfolio management and ongoing investment to maintain an asset's core profile in the long term. An asset will outlive its risk profile moving from core to core+ to value add and opportunistic as its risk characteristics evolve. At AEW our in-house research is key, providing the catalyst for our decision making and portfolio repositioning strategies.

What core can offer investors right now

Core real estate continues to offer investment solutions that meet a lower risk appetite for investors, including stable, sustainable income on long leased core assets that fits well for liability matching strategies and income-focused investors. Core portfolios, if managed well, generally offer less downside volatility as long as appropriate investment is made into the standing assets to keep them in a "core" space, and acquisitions and disposals impact favourably the risk-return profile of the portfolio. Core strategies can also offer a growth aspect in market phases with increasing rent levels.

A lot of the large core institutional investors have attempted to drive outperformance by investing in more specialised strategies, pursuing specific sector, or single sector-market plays on a narrow market call or conviction. For most institutions however, there is a strong need to access core real estate with a diversified multi-sector, multi-country approach.

Timing is important in a market cycle, not in a sense that as an investor you must accurately "call the bottom," but rather in that you recognise phases in the cycle where upside risks outweigh downside risks. Valuations have repriced, debt is accretive and interest rate markets appear to indicate that further drops are expected, even if only marginally from here, and a recovery in core European markets such as France, Spain, the UK and Germany is expected.

For investors who can be among the early movers and deploy capital into markets before the "herd" returns, key factors to success include access to sellers and a disciplined approach to acquisitions. To-date, there hasn't yet been a return of core money back into these markets, so competition for core assets remains relatively low. There will come a tipping point though when enough capital returns, competition increases, and prices and values follow, but for now the window is open.

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